CLERK'S COPY.

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 197

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

vs.

ANNA VICKERS CRAWFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED JULY 3, 1945
CERTIORARI GRANTED OCTOBER 8, 1945

No. 10885

United States

Circuit Court of Appeals

For the Ninth Circuit.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

ANNA VICKERS CRAWFORD,
Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the Tax Court of the United States

Rotary Colorprint, 55 Eleventh Street, San Francisco 60—12-11-44

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES:

For Taxpayer:

GEORGE M. THOMPSON
SIDNEY D. KRYSTAL

For Comm'r:

HAROLD D. THOMAS

Docket No. 111047

ANNA VICKERS CRAWFORD,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1942

May 15—Petition received and filed. Taxpayer notified. Fee paid.

May 16—Copy of petition served on General Counsel.

May 15—Request for Circuit hearing in Los Angeles filed by taxpayer. 5/16/42 copy served.

June 15—Answer filed by General Counsel.

June 18—Copy of answer served on taxpayer—Los Angeles, California.

Aug. 10—Hearing set Sept. 20, 1943—Los Angeles, California.

1943

Sept. 20—Hearing had before Judge Arnold on merits—stipulation of facts filed. Briefs due 11/1/43. Replies 11/16/43.

Nov. 1—Transcript of hearing 9/20/43 filed.

Nov. 2—Motion for leave to file the attached brief, brief lodged, filed by General Counsel. 11/8/43 Granted. Served 11/10/43.

Nov. 9—Brief filed by taxpayer. 11/10/43 copy served.

Nov. 22—Motion for leave to file the attached reply brief, reply brief lodged, filed by taxpayer. 11/23/43. Granted.

Nov. 23—Copy of motion and reply brief served on General Counsel.

1944

Mar. 24—Memorandum opinion rendered—Arnold, J., Div. 12. Decision will be entered under Rule 50. 3/25/44 copy served.

May 16—Computation of deficiency filed by General Counsel.

May 20—Hearing set 6/14/44 on settlement.

June 2—Consent to settlement filed by taxpayer.

June 7—Decision entered, Arnold J., Div. 12.

Aug. 28—Petition for review by U. S. Circuit Court of Appeals, Ninth Circuit, with assignments of error filed by General Counsel.

Sept. 21—Proof of service filed by General Counsel. (Mrs. Anna Vickers Crawford.)

Sept. 21—Proof of service filed by General Counsel. (Sidney D. Krystal, Esq.)

1943

Sept. 23—Designation of contents of record filed by General Counsel.

Sept. 23—Statement of points filed by General Counsel.

Oct. 2—Proof of service of designation of contents of record and statement of points filed by General Counsel. [1*]

United States Board of Tax Appeal

Docket No. 111047

ANNA VICKERS CRAWFORD,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named taxpayer hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency, dated February 27, 1942, bearing the Symbols LA:IT:90D:PB, and as a basis of this proceeding alleges as follows:

I.

The petitioner is an individual, residing in the City of Los Angeles, State of California, with her

*Page numbering appearing at top of page of original certified Transcript of Record.

office at 822 Roosevelt Building, 727 West Seventh Street, Los Angeles, California.

II.

The notice of deficiency, a copy of which is attached hereto and marked Exhibit A, was mailed to the petitioner on February 27, 1942.

III.

The taxes in question are alleged deficiencies in income tax for the year 1938 in the amount of $18,018.01, for the year 1939 in the amount of $16,361.57, and for the year 1940 in the amount of $17,339.48.

IV.

The determination of tax set forth in said notice of deficiency is based upon the following errors: [2]

(a) The Commissioner erred in including in income for 1938 dividends in the sum of $2,650.55 reported by the petitioner in her federal income tax return for the year 1937.

(b) The Commissioner erred in including in income for 1938, oil royalties in the sum of $11,400.30 reported by the petitioner in her federal income tax return for the year 1937.

(c) The Commissioner erred in disallowing a deduction for 1938 for percentage depletion of oil royalties in the amount of $26,462.50.

(d) The Commissioner erred in disallowing a deduction for 1938 for membership fee in the State Chamber of Commerce in the amount of $200.00.

(e) The Commissioner erred in disallowing a

deduction for 1938 for business expenses in the sum of $2,165.78.

(f) The Commissioner erred in including in income for 1939 dividends in the sum of $2,523.88 reported by the petitioner in her federal income tax return for the year 1938.

(g) The Commissioner erred in including in income for 1939 oil royalties in the sum of $10,025.98 reported by the petitioner in her federal income tax return for 1938.

(h) The Commissioner erred in disallowing a deduction for 1939 for percentage depletion of oil royalties in the amount of $23,921.75.

(i) The Commissioner erred in disallowing a deduction for 1939 for membership fee in the State Chamber of Commerce in the amount of $100.00.

(j) The Commissioner erred in disallowing a deduction for 1939 for business expenses in the sum of $2,200.67.

(k) The Commissioner erred in including in income for 1940 dividends in the sum of $1,890.50 and corporation bond interest in the sum of $125.00, both reported by the petitioner in her federal income tax return for the year 1939. [3]

(l) The Commissioner erred in including in income for 1940 oil royalties in the sum of $9,426.02 reported by the petitioner in her federal income tax return for the year 1939.

(m) The Commissioner erred in disallowing a deduction for 1940 for percentage depletion of oil royalties in the amount of $21,997.34.

(n) The Commissioner erred in disallowing a deduction for 1940 for membership fee in the State Chamber of Commerce in the amount of $100.00.

(o) The Commissioner erred in disallowing a deduction for 1940 for business expenses in the sum of $2,061.95.

V.

The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) The petitioner is one of the heirs of J. V. Vickers. The petitioner owns undivided interests in various real properties situated in the State of California, as follows:

(1) 1/3 interest in Rancho LaBallona, hereinafter more particularly described.

(2) 1/7th interest in Kinney Heights Tract, described as Lots 22, 23 and 24 in Block 1 of the Kinney Heights Tract, in the City of Los Angeles, County of Los Angeles, State of California, as per map recorded in Book 78, Page 50 of Miscellaneous Records of said County.

(3) 1/7th interest in Rancho San Rafael.

(4) 1/14th interest in Lots 37, 38 and the Southeasterly Half of Lot 39, in Block 27 of the Wolfskill Orchard Tract, in the City of Los Angeles, County of Los Angeles, State of California, as per map recorded in Book 30, Page 9, et seq. Miscellaneous Records of said County.

(5) 1/7th of a 1/3rd interest in Lots 5, 6, 7, 13, 14, 15 and that portion of Lots 4 and 12 lying Northeasterly of Fifth Street, in [4]

Block 17 of Woolen Mill Tract, in the City of Los Angeles, County of Los Angeles, State of California, as per map recorded in Book 42, Page 409 of Maps.

(6) 1/7th interest in the Rancho Las Bolsas, County of Orange, State of California and described as the Northwest Quarter of the Southeast Quarter of the Northwest Quarter of Section 36, Township 5 South, Range 11 West, S. B. B. & M. estimated to contain 10 acres.

The petitioner also owns diverse securities and other income producing properties.

(b) On or about April 12, 1924, the petitioner, Florence Vickers McAllister and Clara Vickers Naftzger, as Lessors, executed a lease with Standard Oil Company for the drilling of oil on a portion of the said Rancho LaBallona property, in which property each of the said Lessors owned an undivided one-third interest. Said lease is hereinafter referred to as "Standard-Vickers Lease No. 1". A true copy of said lease, marked Exhibit B, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein.

(c) On or about January 6, 1925, petitioner, Florence Vickers McAllister and Clara Vickers Naftzger, as Lessors, executed a lease with the Standard Oil Company for the drilling of oil on another portion of the said Rancho LaBallona property, in which each of said Lessors owned an undivided one-third interest. Said lease is hereinafter referred to as "Standard-Vickers Lease No. 2". A

true copy of said lease, marked Exhibit C, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein.

(d) On or about April 18, 1924, the petitioner, Florence Vickers McAllister and Clara Vickers Naftzger, as Lessors, executed a lease with the Associated Oil Company for the drilling of oil on another portion of the said [5] Rancho LaBallona property, in which each of said Lessors owned an undivided one-third interest. Said lease is hereinafter referred to as "Associated-Vickers Lease". A true copy of said lease, marked Exhibit D, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein.

(e) During the years, 1938, 1939 and 1940, and for many years prior thereto, the petitioner kept her books of account and filed her income tax returns on a combined cash-receipts and disbursements and accrual basis. During said period all income from royalties, rents, dividends and interest was reported on the accrual basis. All disbursements and expenditures were reported on the cash basis. The taxpayer's income tax returns were audited annually, and prior to the year 1940, agents of the Commissioner of Internal Revenue have approved and accepted the basis upon which said returns were filed.

(f) The petitioner received and reported in her tax return for the year 1938 gross royalties received pursuant to the aforesaid three leases in the aggregate sum of $165,850.54. In said return, the peti-

tioner claimed a deduction for percentage depletion of said royalties in the aggregate sum of $45,608.90.

(g) The petitioner received and reported in her income tax return for the calendar year 1939 gross royalties received pursuant to the aforesaid three leases in the aggregate sum of $153,075.82. In said return petitioner claimed a deduction for percentage depletion of said royalties in the aggregate sum of $42,095.85.

(h) The petitioner received and reported in her income tax return for the calendar year 1940, gross royalties received pursuant to the aforesaid three leases in the aggregate sum of $135,773.62. In said return petitioner claimed a deduction for percentage depletion of said royalties in the aggregate sum of $37,337.75. [6]

(i) During the month of January, 1938, the petitioner received dividends in the aggregate sum of $2,650.55. Said dividends accrued on or before December 31, 1937. Petitioner included said dividends in the sum of $2,650.55 in her Federal income tax return for the year 1937.

(j) During the month of January, 1939, the petitioner received dividends in the aggregate sum of $2,523.88. Said dividends accrued on or before December 31, 1938. The petitioner included said dividends in the sum of $2,523.88 in her income tax return for 1938.

(k) During the month of January, 1940, the petitioner received dividends in the sum of $1,890.50 and corporation bond interest in the sum of $125.00. Said dividends and bond interest accrued on or be-

fore December 31, 1939. The petitioner included said dividends in the sum of $1,890.50 and said bond interest in the sum of $125.00 in her Federal income tax return for 1939.

(1) The petitioner is engaged in the business of managing and operating her various property interests. Said property interests include undivided interests in real properties, oil leases, and complete interests in other income producing properties. For the effective and efficient operation of said business, the petitioner, together with the other heirs of the Estate of J. V. Vickers, maintained during the years, 1938, 1939 and 1940, and for many years prior thereto, an office located at 822 Roosevelt Building, 727 West Seventh Street, Los Angeles, California. The petitioner, together with the other heirs of J. V. Vickers, during 1938, 1939 and 1940, employed two employees in said offices. Said employees maintain and keep books of accounts for the petitioner and the other heirs of the Estate of J. V. Vickers, and attend to the management of the property interests involved. During the years, 1938, 1939 and 1940, the petitioner paid 2/7ths of the expenses of maintaining said office. During the year 1938, the petitioner paid the sum of $3,049.11 as her share of the said management expenses. In her federal income tax return for the year 1938 the [7] petitioner took a deduction for said management expenses in the sum of $2,165.78, representing a portion of the total management expenses paid by petitioner determined by the percentage that petitioner's taxable income for the year 1938 bore to

the petitioner's entire income including non-taxable income.

(m) During the year 1939 petitioner paid as her allocable share of said management expenses the sum of $3,126.04. In her federal income tax return for the year 1939 the petitioner claimed a deduction for a portion of said management expenses in the sum of $2,200.67, said portion being determined by the percentage that the petitioner's taxable income bore to her entire income including non-taxable income.

(n) During the year 1940 petitioner paid as her allocable share of said management expenses the sum of $2,909.85. In her federal income tax return for the year 1940 the petitioner claimed a deduction for a portion of said management expenses in the sum of $2,061.95, said portion being determined by the percentage that the petitioner's taxable income bore to her entire income including non-taxable income.

(o) The petitioner, because of her business interests, is a member of the California State Chamber of Commerce. During the year 1938 the petitioner paid her annual membership fee to the California State Chamber of Commerce in the sum of $200.00. The petitioner claimed a deduction in her income tax return for 1938 for said payment in the sum of $200.00.

(p) During the year 1939 the petitioner paid her annual membership fee to the California State Chamber of Commerce in the sum of $100.00. The petitioner claimed a deduction in her income tax

return for 1939 for said payment in the sum of $100.00.

(g) During the year 1940 the petitioner paid her annual membership fee to the California State Chamber of Commerce in the sum of $100.00. The petitioner claimed a deduction in her income tax return for 1940 for said payment [8] in the sum of $100.00.

Wherefore, petitioner prays that this Board may hear the proceeding and determine petitioner's tax liability for the years, 1938, 1939 and 1940; that it be held that there is no deficiency in petitioner's income taxes for the years, 1938, 1939 and 1940; and for such other relief as may appear equitable and proper.

(s) GEORGE M. THOMPSON
CPA ok

(s) SIDNEY D. KRYSTAL Esq ok
Counsel for Petitioner
505 Title Insurance Building
Los Angeles, California

State of California
County of Los Angeles—ss.

Anna Vickers Crawford, being duly sworn, on oath deposes and says that she is the petitioner above named; that she has read the foregoing petition and is familiar with the statements contained therein and that the facts stated therein

are true to the best of her knowledge, information and belief.

/s/ ANNA VICKERS CRAWFORD

Subscribed and sworn to before me this 7th day of May, 1942.

[Seal] /s/ MILDRED SAYLOR

Notary Public in and for the County of Los Angeles, State of California.

My Commission Expires March 2, 1943.

EXHIBIT A

Treasury Department
Internal Revenue Service
12th Floor,
U. S. Post Office and Court House,
Los Angeles, California.

Feb. 27, 1942

Office of
Internal Revenue Agent
In Charge
Los Angeles Division
LA:IT:90D:PB

May 28, 1942

Mrs. Anna V. Crawford,
822 Roosevelt Building,
727 West Seventh Street,
Los Angeles, California.

Madam:

You are advised that the determination of your

income tax liability for the taxable year(s) 1938, 1939 and 1940 discloses a deficiency of $51,719.06 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Los Angeles, California, for the attention of LA:Conf. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
GUY T. HELVERING,
Commissioner,
By (Signed) GEORGE D. MARTIN
Internal Revenue Agent in Charge

Enclosures:
Statement.
Form of Waiver.

PB:fpc [10]

STATEMENT

LA:IT:90D:PB

Mrs. Anna V. Crawford,
822 Roosevelt Building,
727 West Seventh Street,
Los Angeles, California.

Tax Liability for the Taxable Years Ended
December 31 1938,
December 31, 1939
and
December 31, 1940

Income Tax

Year	Liability	Assessed	Deficiency
1938	$61,361.38	$ 43,343.37	$18,018.01
1939	51,012.36	34,650.79	16,361.57
1940	67,366.35	50,026.87	17,339.48
Totals	$179,740.09	$128,021.03	$51,719.06

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated January 30, 1942.

A copy of this letter and statement has been mailed to your representative, Mr. George M. Thompson, 433 South Spring Street, Los Angeles, California, in accordance with the authority contained in the power of attorney executed by you and on file with the Bureau. [11]

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1938

Net income as disclosed by return		$114,550.37
Additional income and unallowable deductions:		
(a) Dividends received	$ 126.67	
(b) Net income from rents and royalties	27,687.08	
(c) Contribution disallowed	200.00	
(d) "Other deductions" disallowed	2,165.78	30,179.53
Net income adjusted		$144,729.90

EXPLANATION OF ADJUSTMENTS

(a) The income from dividends is understated in your return $126.67, due to the omission of $2,650.55 received in January of the taxable year and to the erroneous inclusion of $2,523.88 received in January of the succeeding taxable year.

(b) This adjustment is determined as follows:

Additions:		
1. Gross income understated	$ 1,374.32	
2. Depletion based upon share of lessee's net income disallowed	26,462.50	
Total		$27,836.82
Deduction:		
3. Additional depletion on royalties received	149.74	
Net addition		$27,687.08

[12]

1. The gross income from royalties and that represented by your share of your lessee's net income is understated in your return $1,374.32, due to the omission of $11,400.30 received in January of the taxable year and to the erroneous inclusion of $10,025.98 received in January of the succeeding taxable year.

2. The deduction of percentage depletion claimed with respect to gross income represented

by your share of your lessee's net income is not allowable under the provisions of sections 23(m) and 114(b)(3) of the Revenue Act of 1938.

3. Due to the addition under item 1 of gross income from royalties, an additional deduction for percentage depletion is allowed in the amount of $149.74.

(c) The deduction of $200.00 claimed as a contribution, representing payment to State Chamber of Commerce, is not allowable under the provisions of section 23(o) or section 23(a) of the Revenue Act of 1938.

(d) The amount of $2,165.78 claimed as "other deductions" is disallowed since this amount does not represent an ordinary and necessary expense of carrying on a trade or business within the meaning of section 23(a) of the Revenue Act of 1938.

[13]

COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1938

Net income adjusted		$144,729.90
Plus: Net long-term capital loss		3,862.02
Ordinary net income		$148,591.92
Less: Personal exemption		2,500.00
Balance (surtax net income)		$146,091.92
Less: Interest on U. S. obligations	$ 1,125.00	
Earned income credit	300.00	1,425.00
Net income subject to normal tax		$144,666.92

Normal tax at 4% on $144,666.92		$ 5,786.68
Surtax on	$146,091.92	56,733.31
Partial tax		$ 62,519.99
Minus: 30% of $3,862.02 net long-term capital loss		1,158.61
Alternative tax		$ 61,361.38

[14]

COMPUTATION OF TAX

Taxable Year Ended December 31, 1938

Net income adjusted		$144,729.90
Less: Personal exemption		2,500.00
Balance (surtax net income)		$142,229.90
Less: Interest on U. S. obligations	$ 1,125.00	
Earned income credit	300.00	1,425.00
Net income subject to normal tax		$140,804.90
Normal tax at 4% on $140,804.90	$ 5,632.20	
Surtax on $142,229.90	54,493.34	
Total tax (ordinary)		$ 60,125.54
Alternative tax		$ 61,361.38
Correct income tax liability		$ 61,361.38
Income tax assessed:		
Original, account No. 200657	$ 42,650.08	
Additional, Feb. 1942, account No. 519082	693.29	
Total assessed		43,343.37
Deficiency of income tax		$ 18,018.01

[15]

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1939

Net income as disclosed by return		$160,646.72
Additional income and unallowable deductions:		
(a) Dividends received	$ 633.38	
(b) Net income from rents and royalties	24,518.62	
(c) Contribution disallowed	100.00	
(d) "Other deductions" disallowed	2,200.67	27,452.67
Net income adjusted		$128,099.39

EXPLANATION OF ADJUSTMENTS

(a) The income from dividends is understated in your return $633.38 due to the omission of $2,523.88 received in January of the taxable year and to the erroneous inclusion of $1,890.50 received in January of the succeeding taxable year.

(b) This adjustment is determined as follows:

Additions:		
1. Gross income understated	$ 599.96	
2. Depletion based upon share of lessee's net income disallowed	23,921.75	
Total		$24,521.71
Deduction:		
3. Additional depletion on royalties received		3.09
Net addition		$24,518.62

1. The gross income from royalties and that represented by your share of your lessee's net income is understated in your return $599.96, due to omission of $10,025.98 received in January of the taxable year and to the erroneous inclusion of $9,426.02 received in January of the succeeding taxable year. [16]

2. The deduction of percentage depletion claimed with respect to gross income represented by your share of your lessee's net income is not allowable under the provisions of sections 23(m) and 114(b)(3) of the Internal Revenue Code.

3. Due to the addition under item 1 of gross income from royalties, and additional deduction for percentage depletion is allowed in the amount of $3.09

(c) The deduction of $100.00 claimed as a contribution, representing payment to State Chamber of Commerce, is not allowable under the provisions of section 23(o) or section 23(a) of the Internal Revenue Code.

(d) The amount of $2,200.67 claimed as "other deductions" is disallowed since this amount does not represent an ordinary and necessary expense of carrying on a trade or business within the meaning of section 23(a) of the Internal Revenue Code.

COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1939

Net income adjusted		$128,099.39
Plus: Net long-term capital loss		3,742.95
Ordinary net income		$131,842.34
Less: Personal exemption		2,500.00
Balance (surtax net income)		$129,342.34
Less: Interest on U. S. obligations	$ 1,125.00	
Earned income credit	300.00	1,425.00
Net income subject to normal tax		$127,917.34

Normal tax at 4% on $127,917.34		$ 5,116.69
Surtax on $129,342.34		47,018.56
Partial tax		$ 52,135.25
Minus: 30% of $3,742.95 net long-term capital loss		1,122.89
Alternative tax		$ 51,012.36

[17]

COMPUTATION OF TAX

Taxable Year Ended December 31, 1939

Net income adjusted		$128,099.39
Less: Personal exemption		2,500.00
Balance (surtax net income)		$125,599.39
Less: Interest on U. S. obligations	$ 1,125.00	
Earned income credit	300.00	1,425.00
Net income subject to normal tax		$124,174.39
Normal tax at 4% on $124,174.39	$ 4,966.98	
Surtax on $125,599.39	44,847.65	
Total tax (ordinary)		$ 49,814.63
Alternative tax		$ 51,012.36
Correct income tax liability		$ 51,012.36
Income tax assessed:		
Original, account No. 201449	$33,991.71	
Additional, Feb. 1942, account No. 519083	659.08	
Total assessed		$ 34,650.79
Deficiency of income tax		$ 16,361.57

ADJUSTMENTS TO NET INCOME

Taxable Year Ended December 31, 1940

Net income as disclosed by return		$100,222.61
Additional income and unallowable deductions:		
(a) Dividends received	$ 1,890.50	
(b) Interest received	125.00	
(c) Net income from rents and royalties	30,056.91	
(d) Contribution disallowed	100.00	
(e) "Other deductions" disallowed	2,061.95	34,234.36
Net income adjusted		$134,456.97

[18]

EXPLANATION OF ADJUSTMENTS

(a) The income from dividends is understated in your return $1,890.50 due to the omission of that amount received in January of the taxable year.

(b) The amount of interest reported on Pacific Electric Railway 5% bonds is understated $125.00.

(c) This adjustment is determined as follows:

Additions:		
1. Gross income understated		$ 9,426.02
2. Depletion based upon share of lessee's net income disallowed		21,997.34
Total		$31,423.36
Deduction:		
3. Additional depletion on royalties received		1,366.45
Net addition		$30,056.91

1. The gross income from royalties and that represented by your share of your lessee's net income is understated in your return $9,426.02, due to the omission of that amount received in January of the taxable year.

2. The deduction of percentage depletion claimed with respect to gross income represented by your share of your lessee's net income is not allowable under the provisions of sections 23(m) and 114(b)(3) of the Internal Revenue Code.

3. Due to the addition under item 1 of gross income from royalties, an additional deduction for percentage depletion is allowed in the amount of $1,366.45. [19]

(d) The deduction of $100.00 claimed as a contribution representing payment to State Chamber of Commerce, is not allowable under the provisions of section 23(o) or section 23(a) of the Internal Revenue Code.

(e) The amount of $2,061.95 claimed as "other deductions" is disallowed since this amount does not represent an ordinary and necessary expense of carrying on a trade or business within the meaning of section 23(a) of the Internal Revenue Code.

COMPUTATION OF ALTERNATIVE TAX

Taxable Year Ended December 31, 1940

Net income adjusted		$134,456.97
Plus: Net long-term capital loss		1,218.77
Ordinary net income		$135,675.74
Less: Personal exemption		2,000.00
Balance (surtax net income)		$133,675.74
Less: Interest on U. S. obligations	$ 979.69	
Earned income credit	300.00	1,279.69
Net income subject to normal tax		$132,396.05
Normal tax at 4% on $132,396.05	$ 5,295.84	
Surtax on $133,675.74	56,311.93	
Partial tax		$ 61,607.77
Minus: 30% of $1,218.77 net long-term capital loss		365.63
Alternative tax		$ 61,242.14

[20]

COMPUTATION OF TAX

Taxable Year Ended December 31, 1940

Net income adjusted		$134,456.97
Less: Personal exemption		2,000.00
Balance (surtax net income)		$132,456.97
Less: Interest on U. S. obligations	$ 979.69	
Earned income credit	300.00	1,279.69
Net income subject to normal tax		$131,177.28
Normal tax at 4% on $131,177.28	$ 5,247.09	
Surtax on $132,456.97	55,605.04	
Total tax (ordinary)		$ 60,852.13
Alternative tax		$ 61,242.14
Plus: Defense tax (10% of $61,242.14)		6,124.21
Correct income tax liability		$ 67,366.35
Income tax assessed:		
Original, account No. 202347	$44,030.81	
Additional, Feb. 1942, account No. 519084	5,996.06	
Total assessed		50,026.87
Deficiency of income tax		$ 17,339.48

[Endorsed]: U.S.B.T.A. Filed May 15, 1942.

[21]

[Title of Tax Court and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition of the above-named taxpayer, admits and denies as follows:

I and II. Admits the allegations contained in paragraphs I and II of the petition.

III. Admits that the taxes in question are alleged deficiencies in income tax for the years 1938, 1939 and 1940, but denies the remainder of paragraph III of the petition.

IV—(a) to (o), inclusive. Denies the allegations of error contained in subdivisions (a) to (o), inclusive, of paragraph IV of the petition.

V—(a) to (q), inclusive. Denies the allegations contained in subdivisions (a) to (q), inclusive, of paragraph V of the petition.

VI. Denies each and every allegation contained in the petition not hereinbefore specifically admitted or denied. [22]

Wherefore, it is prayed that the determination of the Commissioner be approved.

(Signed) J. P. WENCHEL

ACB

Chief Counsel, Bureau of Internal Revenue.

Of Counsel:

ALVA C. BAIRD,
Division Counsel.
FRANK T. HORNER,
SAMUEL TAYLOR,
Special Attorneys, Bureau of Internal Revenue.

[Endorsed]: U.S.B.T.A. Filed June 15, 1942.

[23]

[Title of Tax Court and Cause]

STIPULATION OF FACTS

It is hereby stipulated between the parties hereto, by their respective counsel, that the following facts shall be taken as true in this proceeding without prejudice to the right of either party to offer other and further evidence not inconsistent with the facts herein stipulated:

1. Petitioner is an individual residing at 245 Carolwood Drive, Holmby Hills, Los Angeles, California, with her office at Room 822 Roosevelt Building, 727 West 7th Street, Los Angeles, California.

2. Petitioner duly filed income tax returns for each of the taxable years 1938, 1939 and 1940, with the Collector of Internal Revenue for the Sixth District of California.

3. In the notice of deficiency the Commissioner disallowed the following amounts as deductions in determining [24] the taxable net income:

Year	Amount
1938	$2,165.78
1939	2,200.67
1940	2,061.95

Errors as to such disallowances have been set forth by petitioner in subparagraphs (e), (j) and (o) of paragraph IV of the petition. Said amounts incurred and paid by petitioner in the respective years represented ordinary and necessary expenses for the production or collection of taxable income or for the management, conservation or maintenance of property held for the production of

taxable income and are properly allowable as deductions.

4. Petitioner, one of the heirs of J. V. Vickers, deceased December 28, 1912, owned at all times herein mentioned an undivided one-third interest in and to certain real property situated in the County of Los Angeles, State of California, known as Rancho La Ballona, and more particularly described as that portion of the 417.330195 acre tract of land in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramona S. de Machado by the final decree of partition of a portion of said Rancho, had in Case No. 2722, of the District Court, and shown on map recorded in Book 3, page 204, et seq., Miscellaneous Records of said County. [25]

5. On or about April 12, 1924, Petitioner, together with Florence Vickers McAllister and Clara Vickers Naftzger, as Lessors, executed a lease with Standard Oil Company, a California corporation, for the drilling of oil on a portion of the said Rancho La Ballona property referred to in paragraph 4 hereof. A photostat copy of said lease, marked Exhibit 1-A, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein. Said lease was in full force and effect during the calendar years 1938, 1939 and 1940.

6. On or about January 6, 1925, petitioner, together with Florence Vickers McAllister and Clara Vickers Naftzger, as Lessors, executed a lease with Standard Oil Company, a California coporation, for the drilling of oil on another portion of said

Rancho La Ballona property referred to in paragraph 4 hereof. A photostat copy of said lease, marked Exhibit 2B, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein. Said lease was in full force and effect during the calendar years 1938, 1939 and 1940.

7. On or about April 18, 1924, petitioner, together with Florence Vickers McAllister and Clara Vickers Naftzger, as [26] Lessors, executed a lease with Associated Oil Company, a California corporation, for the drilling of oil on another portion of said Rancho La Ballona property referred to in paragraph 4 hereof. A photostat copy of said lease, marked Exhibit 3-C, is attached hereto, incorporated herein by reference, and made a part hereof as though fully set forth herein. Said lease was in full force and effect during the calendar years 1938, 1939 and 1940.

8. In the taxable years 1938, 1939 and 1940 petitioner received from Standard Oil Company a California corporation, pursuant to paragraphs 31-A of the Standard Oil Company leases, dated April 12, 1924, and January 6, 1925, set forth in paragraphs 5 and 6 hereof, gross income from primary royalties in aggregate amounts as follows:

Year	Amount
1938	$50,321.41
1939	45,771.09
1940	39,534.63

9. In the taxable years 1938, 1939 and 1940

the petitioner received from Standard Oil Company, a California corporation, pursuant to paragraphs 31-B of the Standard Oil Company leases, dated April 12, 1924, and January 6, 1925, set forth in paragraphs 5 and 6 hereof, aggregate sums of [27] money as follows:

Year	Amount
1938	$62,327.91
1939	52,693.39
1940	44,506.39

10. In the taxable years 1938, 1939 and 1940, petitioner received in cash royalties from Associated Oil Company, a California corporation, pursuant to paragraphs 22 and 25 of the lease dated April 18, 1924, set forth in paragraph 7 hereof, gross income in aggregate amounts as follows:

Year	Amount
1938	$19,700.03
1939	20,275.00
1940	20,958.88

11. In the taxable years 1938, 1939 and 1940, petitioner received from Associated Oil Company, a California corporation, pursuant to paragraphs 23 and 25 of the lease, dated April 18, 1924, set forth in paragraph 7 hereof, aggregate sums of money as follows:

Year	Amount
1938	$34,729.20
1939	34,883.54
1940	39,941.02

12. In determining the proposed deficiencies for the taxable years 1938, 1939 and 1940, the Com-

missioner included in gross income the respective amounts set forth in paragraphs 8, 9, 10 and 11 hereof. [28]

13. In the notice of deficiency for the taxable years 1938, 1939 and 1940, the Commissioner allowed deductions for statutory depletion at the rate of 27½% of the respective amounts received by petitioner as set forth in paragraphs 8 and 10 hereof.

(Sgd.) GEORGE M. THOMPSON
(Sgd.) SIDNEY D. KRYSTAL
Counsel for Petitioner
J. P. WENCHELL, HDT
Chief Counsel, Bureau of Internal Revenue.
Counsel for Respondent.

HDT/mm 8/27/43

[29]

EXHIBIT 1-A

—/—

Agreement
between
Florence Vickers McAllister
Anna Vickers Crawford
Clara Vickers Naftzger
and
Standard Oil Company

Dated: April 12th, 1924. [30]

This Agreement, made this 12th day of April

1924, between Florence Vickers McAllister, formerly Florence Vickers, Anna Vickers Crawford, formerly Anna Vickers, and Clara Vickers Naftzger, formerly Clara Vickers, each the owner, as her separate property, of an undivided one-third (1/3) interest in the land hereinafter described, herein styled first parties, and Standard Oil Company, a corporation under the laws of the State of California, herein styled second party,

WITNESSETH:

Whereas, the first parties are the owners of the following described real property, situate in the County of Los Angeles, State of California, to wit:

That portion of the 417.330195 acre tract of land in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramona S. de Machado, by the final decree of partition of a portion of said Rancho, had in Case No. 2722, of the District Court and shown on map recorded in Book 3, Page 204 et seq., Miscellaneous Records of said County, described as follows:

Beginning at the Northeasterly corner of Lot "A" of Tract 3755 as per map recorded in Book 41, Page 58 of Maps in the office of the County Recorder of said County; thence South eighty degrees (80°) forty-five minutes (45') East along the Southerly line of said allotment twenty-six hundred sixty-nine and seventy-eight hundredths (2669.78) feet to the Northeasterly corner of Lot "A" of Tract 1892 as per map recorded in Book 21, Page 139 of Maps in said Recorder's office; thence North forty-five degrees (45°) eleven min-

utes (11′) East two hundred twenty and eighty-eight hundredths (220.88) feet, more or less, to Station No. 2 of the exterior patent boundary of said Rancho La Ballona; thence North twenty degrees (20°) forty-six minutes (46′) West along the Easterly patent boundary of said Rancho La Ballona thirty-seven hundred fifty and seven-hundredths (3750.07) feet, more or less, to the Southeasterly corner of the parcel of land conveyed to Emma S. Cone by deed recorded in Book 1743, Page 121 of Deeds in said Recorder's office; thence South sixty-nine degrees (69°) fourteen minutes (14′) West along the Southerly line of the land so conveyed two hundred (200) feet to the Southwesterly corner thereof; thence North sixty-four degrees (64°) three minutes (03′) West seven hundred eighty-three and twenty-eight hundredths (783.28) feet, more or less, to a point bearing North nine degrees (09°) fifteen minutes (15′) East from the point of beginning; thence South nine degrees (09°) fifteen minutes (15′) West thirty-five hundred fifty and ninety-three hundredths (3550.93) feet, more or less, to the point of beginning, containing one hundred fifty (150) acres, more or less; [31] and

Whereas, the parties hereto desire to enter into an arrangement whereby the second party shall develop and operate the said above described real property for oil, gas, asphaltum and other hydrocarbon substances, in accordance with all of the terms and conditions herein set forth:

Now, Therefore, the parties hereto do hereby mutually covenant and agree, each with the others, as follows:

1. The first parties have granted and do hereby grant unto second party, its successors and assigns, the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances (and water for operations hereunder) from, and store the same upon, said land during the term hereinafter provided, with the right to enter on said land at all times for said purposes, and from time to time construct, use, maintain, erect, repair, replace and remove thereon and therefrom all buildings, tanks, machinery, telephone and telegraph lines, and other structures, including all pipe lines, which the second party may desire in carrying on its business and mining operations on said premises, with rights of way for passage over and upon and across, and ingress and egress to and from said premises.

2. The second party shall hold said land, with the appurtenances, for the purposes aforesaid, and subject to the terms and conditions of this agreement, for the term of two (2) years from the date hereof, and, unless otherwise surrendered or forfeited by the second party, so long thereafter as the second party in good faith shall conduct drilling operations thereon as herein provided and as long as oil, gas, asphaltum or other hydrocarbons are produced in paying quantities thereon.

3. Concurrently with the execution of this agreement the second party shall pay to the first parties, in consideration of the rights herein granted by first parties to second party, [32] the sum of Seventy-five Thousand Dollars ($75,000.00).

4. The second party agrees to commence the drilling of a well on said premises within two (2) years from the date hereof and to prosecute the same with reasonable diligence until oil is found in quantities deemed paying quantities by the second party, or to a depth at which further drilling would, in the judgment of the second party, be unprofitable, or it may at any time within said period terminate this agreement and surrender the premises to the first parties, as hereinafter provided; provided, however, that if at any time within twenty-one (21) months from the date hereof oil is discovered in quantities deemed paying quantities by the second party herein in any well which it is now drilling or may hereafter drill on that part of the property of the Los Angeles Investment Company described in that certain notice of agreement of lease dated January 15, 1924, from Los Angeles Investment Company to Standard Oil Company, which was recorded January 25, 1924, in Book 2905, Page 195 of Official Records, Los Angeles County, which property is situate to the east and southeast of the herein described premises, the second party agrees, if it has not theretofore commenced the drilling of a well at some place on the herein described premises, or if it has not theretofore canceled or surrendered this agreement, to commence the drilling of a well at some place on the premises herein described within three (3) months after oil in such paying quantities shall be found in said well which it is now drilling or may hereafter drill on said property of the Los Angeles Investment Company hereinabove referred to, or terminate this agreement.

5. If second party shall not have commenced drilling on the herein described premises or terminated this agreement within one (1) year from the date hereof, second party shall pay or tender the first parties as rental, a sum equal to Ten Dollars ($10.00) ~~per acre~~ per month in advance for the thirteenth [33] month of the term of this agreement, and thereafter a sum equal to Ten Dollars ($10.00) per acre per month in advance for each month of the term hereof until drilling is commenced on the herein described premises, or this agreement terminated as herein provided.

6. If the second party shall elect not to commence the drilling of a well on the herein described premises within said period of two (2) years from date hereof, or within three (3) months after the discovery of oil in such paying quantities in any well which second party is now drilling or may hereafter drill on that part of the Los Angeles Investment Company property referred to in Paragraph 4, or shall elect not to prosecute the drilling of such well as above provided, this agreement shall terminate.

7. Upon the termination of this agreement, as herein provided, an appropriate instrument of termination shall be executed and delivered to the first parties, and the second party shall quit the premises and shall thereafter be relieved from all further obligations hereunder. No implied covenants shall be read into this agreement requiring the second party to drill or to continue drilling on said lands, or fixing the measure of diligence therefor.

8. Should the second party elect to commence the drilling of a well on the herein described premises, as aforesaid, if oil should not be obtained in such paying quantities by the second party in the first well drilled, the second party shall, as a condition of the continuation of any of the rights given to it by this agreement, within ninety (90) days after drilling shall have ceased upon such first well, commence upon the premises the drilling of a second well and shall prosecute the drilling of the same with reasonable diligence until oil is found in such paying quan- [34] tities by the second party, or until said well has been drilled to a depth at which further drilling would, in the judgment of the second party, be unprofitable, and shall likewise continue to drill a well under like terms and conditions and subject to like obligations as long as the second party claims any rights hereunder, and until oil in such paying quantities is struck.

9. If oil is found in such paying quantities in any well so drilled by the second party, the second party (subject to the provisions hereof) shall continue to drill additional wells on said premises as rapidly as at least two (2) strings of tools working with due diligence can complete the same, until there shall have been completed on said premises as many wells as shall equal the total acreage divided by ten, whereupon the second party shall hold the entire premises free of further drilling obligations subject to this agreement, and for the full term thereof; provided that the second party

may, if it so elects, defer the commencement of the drilling of the second or any subsequent well for a period not to exceed ninety (90) days from the date of the completion of the well last preceding. The second party shall be entitled to drill on said premises as many additional wells as it desires.

10. After the completion of the first or any subsequent well herein provided for, whether oil be found therein in such paying quantities or not, the second party may, at its election, at any time cease further drilling, and if said full number of wells shall not have been drilled, the second party shall thereupon surrender this agreement, and this agreement shall thereupon terminate as to all of said premises except ten (10) acres surrounding each producing or drilling well, which the second party may hold free of further drilling obligations as long as oil or gas is produced therefrom, with rights of way for pipe lines upon all of said [35] premises and for passage over and upon and across and ingress and egress to and from said premises. Such ten (10) acres shall in each instance be in the form of a square or rectangle, the longer sides of which shall not exceed twice the length of the shorter sides. At the expiration of the term of twenty (20) years from the date hereof, no further well shall be drilled by ~~the second~~ party upon the premises, except with the written consent of the first parties.

11. In the event that wells are drilled and oil produced in paying quantities upon property adjoining the land herein described, and within two

hundred fifty (250) feet of the boundary line of the property herein described, the second party agrees to protect the first parties boundary line by offsetting such wells by the commencement of actual drilling within ninety (90) days after discovery of oil in paying quantities in such wells. Such offset well or wells, if any, to be considered the equivalent in all respects of any other well required to be drilled hereunder.

12. Any gasoline derived from gas produced from the premises shall be returned to the oil produced therefrom and shall be treated as a part thereof.

13. The second party shall not be required to account to the first parties for or pay for any oil, gas or water produced by the second party from the premises and used by it in its operations hereunder, but may use such oil, gas and water free of charge.

14. Water produced by the second party may, if and while the same is not used by it in its operations hereunder, be used by the first parties for surface operations on the premises.

15. In the event gas is produced on the herein described premises in excess of the requirements of the second party for its operations hereunder, and the second party does not sell or otherwise dispose of same, first parties shall have the right to take [36] and use for domestic purposes on the herein described premises, such excess gas, free of cost; provided, however, that such taking of gas shall be at a point designated by second party and at

the sole cost and expense of first parties, and the second party shall not be accountable or answerable for any damage or injury arising out of such taking or use of gas.

16. The second party agrees to operate each completed well on the premises to its full capacity, so long as such well shall produce oil in quantities deemed paying quantities by the second party, while this agreement is in force as to the portion of the premises on which such well is situated. The drilling or pumping obligations of the second party hereunder shall be suspended, while, but only so long as, the second party is prevented from complying therewith, in part or in whole, by strikes, lockouts, acts of God, unavoidable accidents, or other matters beyond the control of the second party, whether similar to the matters herein specifically enumerated or not.

17. The second party shall pay all taxes that may be levied against the improvements, plant, machinery and personal property owned by it and located upon any part of the said premises, including oils and minerals that may be stored on said premises.

18. The second party shall also pay any and all taxes assessed upon the mineral rights in said premises, or on such portion of said premises as the second party is holding under this agreement.

19. The first parties agree to pay all other taxes assessed upon said premises, whether the same are

assessed to the second party or to the first parties, or otherwise.

20. The first parties shall have the right to examine at all times the premises herein described, and the work done, [37] and in progress thereon, and the production therefrom, and shall also have the right to inspect the books kept by the second party in relation to said property, to ascertain the production and the amount shipped therefrom. The second party agrees, on request, to furnish the first parties with copies of logs of all wells drilled by the second party on the land herein described.

21. The second party shall promptly notify the first parties of any judicial proceedings brought to the attention of the second party, and purporting to affect or affecting its possession hereunder.

22. The second party shall have the right to remove from time to time from said premises all machinery, rigs, piping, casing, pumping stations and other property and improvements belonging to or furnished by second party, provided that such removal shall be completed within a reasonable time after the termination of this agreement, and provided further that if at any time during its operations upon the within described premises, any well drilled by second party shall prove to be a non-paying well, or shall prove to be a water well, and the second party shall not desire to further drill or operate said well for the production of oil or gas, or shall cease operation upon said well or wells, second party shall notify first parties of

that fact and shall not remove any casing from said well or wells without first affording the first parties the opportunity of purchasing all or any portion of the casing therein; and if the first parties desire to purchase the same, they shall pay for the casing desired fifty per cent (50%) of the market price of similar casing of like size and gauge obtainable at that time in the Los Angeles market.

23. All the labor to be performed and material to be furnished in the operations hereunder shall be at the cost and [38] expense of the said second party, except in so far as the proceeds of the oil, gas, asphaltum or other hydrocarbon substances produced from the land herein described, shall pay for the same, as provided in this agreement, and the first parties shall not be chargeable with, nor liable for, any part thereof, and during the life of this agreement second party shall keep the lands herein described duly and fully protected against all liens of every character arising from, or connected with, its operations, and in the event of any such liens being placed thereon to the knowledge of second party, it shall at once notify the first parties thereof.

24. Upon the written request of first parties, the second party agrees to lay all pipe lines which it constructs through cultivated fields below plow depth, and upon similar request agrees to fence all sumps dug on the property.

25. The second party agrees to pay all damages directly occasioned by its operations to growing

crops upon said premises. In the event of inability of the parties to agree as to the amount of any such damage, such amount shall be determined by arbitration, one arbitrator to be selected by the first parties, one by the second party, and, if the two so selected shall be unable to agree, they shall select a third arbitrator. The decision of a majority of said three arbitrators shall be binding on the parties.

26. The term "gross proceeds" as used in this agreement, shall mean and include:

(a) The "sale value" as hereinafter defined, of all oil, asphaltum and other hydrocarbon substances other than gas, extracted and saved from said premises by the operations of second party thereon; and

(b) The actual proceeds of all gas produced and saved and sold off the premises by the second party, it [39] being understood and agreed that second party shall be under no obligation to produce, save, sell or otherwise dispose of gas from said premises or any well thereon.

27. The term "sale value" of all oil, asphaltum and other hydrocarbon substances produced from said premises other than gas, shall be defined to mean the value of said products at the current prices paid therefor by second party from time to time to producers of products of like character, gravity and quality in the same vicinity.

28. The term "chargeable expenses" as used in this agreement shall mean and include:

(a) The sum of Seventy-five Thousand Dollars

($75,000.00) (without interest) which under the terms of this agreement second party is required to pay to first parties.

(b) All sums paid to first parties by second party as rental under the provisions of Paragraph Five (5) of this agreement.

(c) The entire cost and expense to the second party of equipping, exploiting, developing and operating said premises, and of producing oil, gas, asphaltum and other hydrocarbon substances thereon and therefrom in accordance with the terms of this agreement, and of delivering said products to stock tanks upon the premises for transportation therefrom.

(d) Such portion of overhead expenses as are paid for field superintendency in connection with the operations under this agreement.

(e) The cost of repairs, replacements and upkeep of all property and improvements upon the said premises belonging to or furnished by second party for use in connection [40] with its operations under this agreement.

(f) All taxes which, under the terms of this agreement, shall be paid by second party.

(g) All sums paid out by second party as compensation for, or in settlement of, any crop damage.

29. The term "net profits" of the operations hereunder as used in this agreement, and as applied at any particular time, shall mean the amount by which the "gross proceeds" derived from the property up to that time shall exceed the "chargeable expenses" paid and incurred up to the same time

in connection with the operations under this agreement.

30. The second party shall keep true and correct books of account showing the production of oil, asphaltum and other hydrocarbon substances from the said premises and the proceeds of all gas produced and saved and sold off the premises during each calendar month, as well as all other data necessary or proper for the stttlement of the accounts between the parties hereto and the proper adjustment of their rights under this agreement. Not later than the last day of the first calendar month following the month in which oil shall be discovered in a well on said premises, in quantities deemed paying quantities by the second party, the second party shall deliver to first parties an itemized written statement showing the production of said premises, and the "gross proceeds" derived from the operations on said premises and all "chargeable expenses" paid and incurred by second party, up to the end of such preceding month; and thereafter, and not later than the end of each calendar month, the second party shall deliver to first parties similar written statements showing the production of said premises, and the "gross proceeds" derived, and the "chargeable expenses" paid and incurred, during the preceding calendar month.

31. At the end of each calendar month commencing with and including the month next succeeding the month in which oil [41] shall be discovered on said premises in such paying quantities by the second party, the second party (at the time of deliver-

ing to first parties the statements hereinabove provided for) shall account to the first parties, and pay to them:

A. As a minimum:

(1) A sum representing the "sale value" as herein defined of the one-fifth (1/5th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.

(2) One-fifth (1/5th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.

B. Such sum, if any, in addition, as shall represent the amount by which one-half (½) of the "net profits" derived from the operations on said property up to the end of such calendar month shall exceed the aggregate of—

(1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus

(2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

32. The second party shall pay all amount due first parties under this agreement as follows: One-third (1/3) to Florence Vickers McAllister; one-third (1/3) to Anna Vickers Crawford; one-third (1/3) to Clara Vickers Naftzger. Such payments shall be made to the parties at 1001 Story Building, Los Angeles, California, or second party may, at

its option, deposit the same to the credit of the first parties in the Pacific- [42] Southwest Trust and Savings Bank, Sixth and Spring Streets, Los Angeles, California, its successors and any bank or trust company with which it may become merged or which may acquire its banking business.

33. Second party shall not assign this agreement nor sublet the premises (except to the successor or successors, if any, in the business of the second party) without the consent, in writing, of said first parties.

34. If the second party shall fail, for a period of ninety (90) days after written notice given to it at its office in San Francisco, California; by first parties, to comply with any provision of this agreement, the first parties may, at their option, terminate this agreement; provided, that no default in the performance of any of the conditions or provisions hereof as to any well or wells on any parcel of ten (10) acres surrounding the same, as hereinbefore provided, shall affect the right of second party to continue its possession or operation of any other well or wells situated on any other such parcel of ten (10) acres.

In Witness Whereof, the parties hereto have caused this agreement to be executed the day and year first hereinabove written.

FLORENCE VICKERS
McALLISTER
ANNA VICKERS CRAWFORD
CLARA VICKERS NAFTZGER
STANDARD OIL COMPANY
By H. M. STOREY
Vice-President

[Marginal initials]: O. K.—H.H.A.

By S. G. HANSON
Asst. Secretary [43]

State of California
County of Los Angeles—ss.

On this 12th day of April A. D., 1924 before me, Florence E. Lea, a Notary Public in and for the said County and State, residing therein, duly commissioned and sworn, personally appeared Florence Vickers McAllister, Anna Vickers Crawford and Clara Vickers Naftzger known to me to be the persons whose names are subscribed to the within Instrument, and acknowledged to me that they executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year in this Certificate first above written.

[Seal] FLORENCE E. LEA
Notary Public in and for said
County and State.

State of California,
City and County of San Francisco—ss.

On this 17th day of April, in the year of our Lord One Thousand Nine Hundred and twenty-four, before me, Frank L. Owen, a Notary Public in and for said City and County and State, residing therein, duly commissioned and sworn, personally appeared H. M. Storey and S. G. Hanson, Vice-president and Assistant Secretary, respectively of Standard Oil Company, the Corporation described in and that executed the within instrument, and also known to me to be the persons who executed it on behalf of the said Corporaton therein named, and they acknowledged to me that such Corporation executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my Official Seal, at my office in the City and County and State aforesaid the day and year in this certificate first above written.

[Seal] FRANK L. OWEN.
Notary Public in and for said City and County of San Francisco, State of California.

EXHIBIT 2-B

Agreement
between
Florence Vickers McAllister,
et al.,
and
Standard Oil Company

Dated: January 6th, 1925. [44]

This Agreement, dated this 6th day of January, 1925, between Florence Vickers McAllister formerly Florence Vickers, Anna Vickers Crawford, formerly Anna Vickers, and Clara Vickers Naftzger, formerly Clara Vickers, each the owner, as her separate property, of an undivided one-third (1/3) interest in the land hereinafter described, herein styled first parties, and Standard Oil Company, a corporation under the laws of the State of California, herein styled second party.

Witnesseth:

Whereas, the first parties are the owners of the following described real property, situate in the County of Los Angeles, State of California to-wit:

That portion of the 417.330195 Acre tract of land in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramona S. de Machado by the final decree of partition of a portion of said Rancho, had in Case No. 2722 of the District Court and shown on Map recorded in Book 3, Page 204, et seq., Miscellaneous Records of said County, described as follows:

Beginning at the Southwesterly corner of the

Exhibit 2-B—(Continued)

parcel of land conveyed to Emma S. Cone by deed recorded in Book 1743, Page 121, of Official Records of said County, thence North sixty-four degrees (64°) three minutes (03') West seven hundred eighty-three and twenty-eight hundredths (783.28) feet, more or less, to a point bearing North nine degrees (9°) fifteen minutes (15') East from the Northeasterly corner of Lot A, of Tract No. 3755, as per map recorded in Book 41, Page 58, of Maps, in the office of the County Recorder of said County; thence South nine degrees (9°) fifteen minutes (15') West one thousand nine hundred forty (1,940) feet to the true point of beginning; thence North eighty degrees (80°) forty-five minutes (45') West two hundred fifty-five (255) feet to a point; thence North thirteen degrees (13°) twelve minutes (12') thirty seconds (30") West two thousand seven hundred seventy-four and thirty-eight hundredths (2,774.38) feet to a point; thence North fifty-eight degrees (58°) thirty minutes (30') West two hundred fifteen (215) feet, more or less, to a point in the Westerly boundary line of said 417.330195 Acre tract, distant thereon South thirty-one degrees (31°) thirty minutes (30') West one thousand seven hundred sixty-five (1,765) feet from the Southwesterly corner of the land conveyed to Harry D. Brown, Jr., by deed dated January 17, 1919, recorded in Book 6795, Page 85, of Deeds; thence South thirty-one degrees (31°) thirty minutes (30') West along said Westerly line one thousand one hundred eighty-three and fifty hundredths (1,183.50) feet,

Exhibit 2-B—(Continued)

more or less, to an angle point therein; [45] thence South fifty-eight degrees (58°) thirty minutes (30′) East two hundred fifteen (215) feet to a point; thence South thirteen degrees (13°) twelve minutes (12′) thirty seconds (30″) East two thousand six hundred twenty-six (2,626) feet to a point; thence South nine degrees (9°) fifteen minutes (15′) West six hundred fifty-two and seventy hundredths (652.70) feet to a point in the Southerly boundary line of said 417.33095 Acre tract; thence South eigthy degrees (80°) forty-five minutes (45′) East along said Southerly line seven hundred fifty-nine and eigthy-two hundredths (759.82) feet to the Northeast corner of Lot A, Tract No. 3755, as per map recorded in Book 41, Page 58, or Maps, in the Office of the County Recorder of said County; thence North nine degrees (9°) fifteen minutes (15′) East one thousand six hundred ten and ninety-three hundredths (1,610.93) feet, more or less, to the true point of beginning, containing eighty (80) acres, more or less;

and

Whereas, the parties hereto desire to enter into an arrangement whereby the second party shall develop and operate the said above described real property for oil, gas, asphaltum and other hydrocarbon substances, in accordance with all of the terms and conditions herein set forth.

Now, Therefore, the parties hereto do hereby

Exhibit 2-B—(Continued)

mutually covenant and agree, each with the others, as follows:

1. The first parties have granted and do hereby grant unto second party, its successors and assigns, the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances (and water for operations hereunder) from, and store the same upon, said land during the term hereinafter provided, with the right to enter on said land at all times for said purposes, and from time to time construct, use, maintain, erect, repair, replace and remove thereon and therefrom all buildings, tanks, machinery, telephone and telegraph lines, and other structures, including all pipe lines, which the second party may desire in carrying on its business and mining operations on said premises with rights of way for passage over and upon and across, and ingress and egress to and from said premises.

2. The second party shall hold said land, with the appur- [46] tenances, for the purposes aforesaid, and subject to the terms and conditions of this agreement, for the term of five (5) years from the date hereof, and so long thereafter as oil, gas, asphaltum, or other hydrocarbon substances are produced in paying quantities thereon, unless otherwise surrendered or forfeited by the second party.

3. Concurrently with the execution of this agreement the second party shall pay to the first parties in consideration of the rights herein granted by

Exhibit 2-B—(Continued)

first parties to second party, the sum of Eighty Thousand Dollars ($80,000.00).

4. The second party agrees to commence operations for the drilling of a well on said premises within sixty (60) days from the date hereof, and shall prosecute said operations and the drilling of said well with reasonable diligence, until oil is found in quantities deemed paying quantities by the second party, or to a depth at which further drilling would, in the judgment of the second party, be unprofitable.

5. If oil should not be obtained in such paying quantities by the second party in the first well drilled, the second party shall, as a condition of the continuation of any of the rights given to it by this present instrument, within ninety (90) days after drilling shall have ceased upon such first well, commence upon the premises the drilling of a second well and shall prosecute the drilling of the same with reasonable diligence until oil is found in such paying quantities by the second party, or until said well has been drilled to a depth at which further drilling would, in the judgment of second party, be unprofitable, and shall likewise continue to drill a well under like terms and conditions and subject to like obligations as long as second party claims any rights hereunder, and until oil in such paying quantities is struck.

6. If oil is found in such paying quantities in any well [47] so drilled by second party on the premises, the second party (subject to the pro-

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Exhibit 2-B—(Continued)

visions hereof) shall continue to drill additional wells on said premises as rapidly as at least one (1) string of tools, working with due diligence, can complete the same, until there shall have been completed on said premises as many wells as shall equal the total acreage divided by five (5), whereupon the second party shall hold the entire premises free of further drilling obligations, subject to this agreement, and for the full term thereof; provided that the second party may, if it so elects, defer the commencement of the drilling of the second or any subsequent well for a period not to exceed ninety (90) days from the date of the completion of the well last preceding. The second party shall be entitled to drill on said premises as many additional wells as it desires.

7. After the completion of the first or any subsequent well herein provided for, whether oil be found therein in such paying quantities or not, the second party may, at its election, at any time cease further drilling, and if said full number of wells shall not have been drilled, the second party shall thereupon surrender this agreement, and this agreement shall thereupon terminate as to all of said premises except five (5) acres surrounding each producing or drilling well, which the second party may hold free of further drilling obligations as long as oil or gas is produced therefrom, with rights of way for pipe lines upon all of said premises and for passage over and upon and across and ingress and egress to and from said premises.

Exhibit 2-B—(Continued)

Such five (5) acres shall in each instance be in the form of a square or rectangle, the longer sides of which shall not exceed twice the length of the shorter sides.

8. In the event that wells are drilled and oil produced in paying quantities upon property adjoining the land herein de- [48] scribed and within two hundred fifty (250) feet of the boundary line of the property herein described, the second party agrees to protect the first parties' boundary line by offsetting such wells by the commencement of actual drilling within ninety (90) days after discovery of oil in paying quantities in such wells. Such offset well or wells, if any, to be considered the equivalent in all respects of any other well required to be drilled hereunder.

9. Any gasoline derived from gas produced from the premises shall be returned to the oil produced therefrom and shall be treated as a part thereof.

10. The second party shall not be required to account to the first parties for or pay for any oil, gas or water produced by the second party from the premises and used by it in its operations hereunder, but may use such oil, gas and water free of charge.

11. The second party agrees to operate each completed well on the said premises to its full capacity, so long as such well shall produce oil in quantities deemed paying quantities by second

Exhibit 2-B—(Continued)

party, while this agreement is in force as to the portion of the premises on which such well is situated.

12. The drilling or pumping obligations of the second party shall be suspended while, but only so long as, second party is prevented from complying therewith, in part or in whole, by strikes, lockouts, acts of God, unavoidable accidents, or other matters beyond the control of the second party, whether similar to the matters herein specifically enumerated or not.

13. Water produced by the second party may, if and while the same is not used by it in its operations hereunder, be used by the first parties for surface operations on the premises.

14. In the event gas is produced on the herein described premises in excess of the requirements of the second party for its [49] operations hereunder, and the second party does not sell or otherwise dispose of same, first parties shall have the right to take and use for domestic purposes on the herein described premises, such excess gas, free of cost; provided, however, that such taking of gas shall be at a point designated by second party and at the sole cost and expense of first parties, and the second party shall not be accountable or answerable for any damage or injury arising out of such taking or use of gas.

15. The second party shall pay all taxes that may be levied against the improvements, plant, machinery and personal property owned by it and

Exhibit 2-B—(Continued)

located upon any part of the said premises, including oils and minerals that may be stored on said premises.

16. The second party shall also pay any and all taxes assessed upon the mineral rights in said premises, or on such portion of said premises as the second party is holding under this agreement.

17. The first parties agree to pay all other taxes assessed upon said premises, whether the same are assessed to the second party or to the first parties, or otherwise.

18. The first parties shall have the right to examine at all times the premises herein described, and the work done, and the progress thereon, and the production therefrom, and shall also have the right to inspect the books kept by the second party in relation to said property, to ascertain the production and the amount shipped therefrom. The second party agrees, on request, to furnish the first parties with copies of logs of all wells drilled by the second party on the land herein described.

19. The second party shall promptly notify the first parties of any judical proceedings brought to the attention of the second party, and purporting to affect or affecting its possession hereunder.

20. The second party shall have the right to remove from time to time from said premises all machinery, rigs, piping, casing, [50] pumping stations and other property and improvements belonging to or furnished by second party, provided that such removal shall be completed within a reasonable time after the termination of this agree-

Exhibit 2-B—(Continued)

ment, and provided further that if at any time during its operations upon the within described premises, any well drilled by second party shall prove to be a non-paying well, or shall prove to be a water well, and the second party shall not desire to further drill or operate said well for the production of oil or gas, or shall cease operation upon said well or wells, second party shall notify first parties of that fact and shall not remove any casing from said well or wells without first affording the first parties the opportunity of purchasing all or any portion of the casing therein; and if the first parties desire to purchase the same, they shall pay for the casing desired fifty per cent (50%) of the market price of similar casing of like size and gauge obtainable at that time in the Los Angeles market.

21. All the labor to be performed and material to be furnished in the operations hereunder shall be at the cost and expense of the said second party, except in so far as the proceeds of the oil, gas, asphaltum or other hydrocarbon substances produced from the land herein described, shall pay for the same, as provided in this agreement, and the first parties shall not be chargeable with, nor liable for, any part thereof, and during the life of this agreement second party shall keep the lands herein described duly and fully protected against all liens of every character arising from, or connected with, its operations, and in the event of any such liens being placed thereon to the knowledge of second

Exhibit 2-B—(Continued)

party, it shall at once notify the first parties thereof.

22. Upon the written request of first parties, the second party agrees to lay all pipe lines which it constructs through cul- [51] tivated fields below plow depth, and upon similar request agrees to fence all sumps dug on the property.

23. The second party agrees to pay all damages directly occasioned by its operations to growing crops upon said premises. In the event of inability of the parties to agree as to the amount of any such damage, such amount shall be determined by arbitration, one arbitrator to be selected by the first parties, one by the second party, and, if the two so selected shall be unable to agree, they shall select a third arbitrator. The decision of a majority of said three arbitrators shall be binding on the parties.

24. Second party shall not assign this agreement nor sublet the premises (except to the successor or successors, if any, in the business of the second party) without the consent, in writing, of said first parties.

25. If the second party shall fail for a period of ninety (90) days after written notice given to it at its office in San Francisco, California, by first parties, to comply with any provision of this agreement, the first parties may, at their option, terminate this agreement; provided, that no default in the performance of any of the conditions or provisions hereof as to any well or wells on any parcel of five (5) acres surrounding the same, as here-

Exhibit 2-B—(Continued)

inbefore provided, shall affect the right of second party to continue its possession or operation of any other well or wells situated on any other such parcel of five (5) acres.

26. The term "gross proceeds" as used in this agreement shall mean and include:

(a) The "sale value", as hereinafter defined, of all oil, asphaltum and other hydrocarbon substances other than gas extracted and saved from said premises by the operations of second party thereon; and

(b) The actual proceeds of all gas produced and saved and sold off the premises by the second party to itself or [52] otherwise, it being understood and agreed that second party shall be under no obligations to produce, save, sell or otherwise dispose of gas from said premises or any well thereon.

27. The term "sale value" of all oil asphaltum and other hydrocarbon substances produced from said premises other than gas, shall be defined to mean the value of said products at the current prices paid therefor by second party from time to time to producers of products of like character, gravity and quality in the same vicinity.

28. The term "chargeable expenses" as used in this agreement shall mean and include:

(a) The sum of Eighty Thousand Dollars ($80,000.00) (without interest) under the terms of this

Exhibit 2-B—(Continued)

agreement to be paid by second party to first parties.

(b) The entire cost and expense to the second party of equipping, developing and operating said premises, and of producing oil, gas, asphaltum and other hydrocarbon substances thereon and therefrom in accordance with the terms of this agreement, and of delivering said products to stock tanks upon the premises for transportation therefrom.

(c) Such portion of overhead expenses as are paid for field superintendency in connection with the operations under this agreement.

(d) The cost of repairs, replacements and upkeep of all property and improvements upon the said premises belonging to or furnished by second party for use in connection with its operation under this agreement.

(e) All taxes which, under the terms of this agreement, shall be paid by second party. [53]

(f) All sums paid out by second party as compensation for, or in settlement of, any crop or other damage, or any injury cause by, or resulting from, its operations under this agreement.

29. The term "net profits" of the operations hereunder as used in this agreement, and as applied at any particular time, shall mean the amount by which the "gross proceeds" derived from the property up to that time shall exceed the "chargeable expenses" paid and incurred up to the same time in connection with the operations under this agreement.

Exhibit 2-B—(Continued)

30. The second party shall keep true and correct books of account showing the production of oil, asphaltum and other hydracarbon substances from the said premises and the proceeds of all gas produced and saved and sold off the premises during each calendar month, as well as all other data necessary or proper for the settlement of the accounts between the parties hereto and the proper adjustment of their rights under this agreement. Not later than the last day of the first calendar month following the month in which oil shall be discovered in a well on said premises, in quantities deemed paying quantities by the second party, the second party shall deliver to first parties an itemized written statement showing the production of said premises, and the "gross proceeds" derived from the operations on said premises and all "chargeable expenses" paid and incurred by second party, up to the end of such preceding month; and thereafter, and not later than the end of each calendar month, the second party shall deliver to first parties similar written statements showing the production of said premises, and the "gross proceeds" derived, and the "chargeable expenses" paid and incurred, during the preceding calendar month.

31. At the end of each calendar month commencing with and including the month next succeeding the month in which oil shall [54] be discovered on said premises in such paying quantities by the second party, the second party (at the time of delivering to first parties the statements herein-

Exhibit 2-B—(Continued)

above provided for) shall account to first parties, and pay to them:

A. As a minimum:

(1) A sum representing the "sale value" as herein defined of the one-sixth (1/6th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.

(2) One sixth (1/6th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.

B. Such sum, if any, in addition, as shall represent the amount by which one-half (½) of the "net profits" derived from t e operations on said property up to the end of such calendar month shall exceed the aggregate of——

(1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus

(2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

32. The second party shall pay all amounts due first parties under this agreement as follows: One-third (1/3) to Florence Vickers McAllister; one-third (1/3) to Anna Vickers Crawford; one-third (1/3) to Clara Vickers Naftzger. Such payments shall be made to the parties at 1001 Story Building, Los Angeles, California, or second party may, at its option deposit the same to the credit of

Exhibit 2-B—(Continued)

the first parties in the Pacific-Southwest Trust & Savings Bank, [55] Sixth and Spring Streets, Los Angeles, California, its successors and any bank or trust company with which it may become merged or which may acquire its banking business.

In Witness Whereof, the parties hereto have caused this agreement to be executed.

FLORENCE VICKERS
McALLISTER
ANNA VICKERS CRAWFORD
CLARA VICKERS NAFTZGER
STANDARD OIL COMPANY
By R. J. HANNA
Vice-President
By S. G. HANSON
Asst. Secretary

State of California
County of Los Angeles—ss.

On this 6th day of January, in the year nineteen hundred and twenty-five, A. D., before me, Alice B. Tobey, a Notary Public in and for the said County of Los Angeles, State of California residing therein, duly commissioned and sworn, personally appeared Florence Vickers McAllister; Anna Vickers Crawford and Clara Vickers Naftzger personally known to me to be the persons whose names are subscribed to the within instrument and acknowledged to me that they executed the same.

Exhibit 2-B—(Continued)

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

ALICE B. TOBEY

Notary Public in and for Los Angeles County, State of California.

My Commission expires March 24th, 1927.

State of California,
City and County of San Francisco—ss.

On this ninth day of January, in the year of our Lord One Thousand Nine Hundred and Twenty-Five, before me, Frank L. Owen, a Notary Public in and for said City and County and State, residing therein, duly commissioned and sworn, personally appeared R. J. Hanna and S. G. Hanson known to me to be the Vice-President and Assistant Secretary, respectively of Standard Oil Company the Corporation described in and that executed the within instrument, and also known to me to be the persons who executed it on behalf of the said Corporation therein named, and they acknowledged to me that such Corporation executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my Official Seal, at my office in the City and County and State aforesaid the day and year in this certificate first above written.

[Seal] FRANK L. OWEN

Notary Public in and for said City and County of San Francisco, State of California. [56]

EXHIBIT 3-C

This Indenture of Lease, made and entered into this 18th day of April, 1924, between Florence Vickers McAllister, formerly Florence Vickers, Anna Vickers Crawford, formerly Anna Vickers and Clara Vickers Naftzger, formerly Clara Vickers, each the owner as her separate property, of an undivided one-third (1/3) interest in the land hereinafter described, herein called the Lessors, and Associated Oil Company, a corporation duly organized and existing under the laws of the State of California, hereinafter called the Lessee;

Witnesseth:

1. That, Whereas, the said Lessors are the owners of that certain real property situate in the County of Los Angeles, State of California, described as follows, to-wit;

That portion of the 417.330195 acre tract of land, in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramona S. de Machado, by the final decree of partition of a portion of said Rancho, had in Case No. 2722, of the District Court and shown on Map recorded in Book 3, Page 204, et seq., Miscellaneous Records of said County, described as follows:

Beginning at a point in the Easterly boundary line of said 417.330195 acre Tract distant therein South Twenty Degrees (20°) forty-six minutes (46') East three hundred thirty-two and eight tenths (332.8) feet from Station 1 thereof; being

Exhibit 3-C—(Continued)

the southeasterly corner of the land conveyed to Harry D. Brown, Jr., by deed dated January 17th, 1919, recorded in Book 6795, Page 85 of Deeds; thence South twenty degrees (20°) forty-six minutes (46') East along said easterly boundary line nineteen hundred Eighty-five and twelve hundredths (1985.12) feet, more or less to the Northeasterly corner of the Parcel of land conveyed to Emma S. Cone by deed recorded in Book 1743, Page 121 of Official Records of said County; thence South sixty-nine degrees (69°) fourteen minutes (14') West along the Northerly line of the land so conveyed to Cone two hundred (200) feet to the Northwesterly corner thereof; thence South twenty degrees (20') forty-six minutes (46') East along the Westerly line of the land so conveyed to Cone Nine hundred forty-one and eight tenths (941.8) feet, more or less to the southwesterly corner thereof; thence North sixty-four degrees (64°) three minutes (03') West seven hundred eighty-three and twenty-eight hundredths (783.28) feet, more or less, to a point bearing North Nine degrees (9°) fifteen minutes (15') East from the Northeastefly corner of Lot "A" of Tract Number thirty-seven hundred fifty-five (3755) as per Map recorded in Book 41, Page 58 of Maps in the Office of the County Recorder of said County; thence South Nine degrees (9°) fifteen minutes (15') West Nineteen hundred forty (1940) feet; thence North Eighty degrees (80°) forty-five minutes (45') West two hundred fifty-five (255) feet; thence North [57] thirteen de-

Exhibit 3-C—(Continued)

grees (13°) twelve minutes (12′) thirty seconds (30″) West twenty-seven hundred seventy-four and thirty-eight hundredths (2774.38) feet; thence North fifty-eight degrees (58°) thirty minutes (30′) West two hundred fifteen (215) feet, more or less, to a point in the Westerly boundary line of said 417.330195 acre Tract distant thereon South thirty-one degrees (31°) thirty minutes (30′) West seventeen hundred sixty-five (1765) feet from the southwesterly corner of the land so conveyed to Harry D. Brown, Jr., thence North thirty-one degrees (31°) thirty minutes (30′) East along said Westerly boundary seventeen hundred sixty-five (1765) feet to the last mentioned southwesterly corner; thence North eighty-six degrees (86°) fifteen minutes (15′) East along the southerly line of the land so conveyed to Brown three hundred twelve and seventy-eight hundredths (312.78) feet, more or less, to the point of beginning; and containing 101 acres, more or less.

2. Now, Therefore, for and in consideration of the rents and royalties hereinafter agreed to be paid by the said Lessee to the Lessors, and the covenants and conditions hereinafter contained on the part of the respective parties hereto to be performed, the Lessors do by these presents lease, let and demise unto the Lessee, and the Lessee does hereby hire and take from the Lessors, all of said real property hereinabove described, subject to the easements granted of record for road purposes, ditch purposes, and for water pipe lines and con-

Exhibit 3-C—(Continued)

duits; for the term of years beginning with the date hereof and ending on the 17th day of April 1944, for the purpose and with the sole and exclusive right to the Lessee of exploiting and drilling for, developing, producing, extracting, bringing to the surface, obtaining, taking, storing, removing and carrying away petroleum, oil, natural, gas naptha, and other mineral oil and hydrocarbon substances in, upon and from said land, and to erect, maintain, construct and operate upon and in said land such structures, appliances, apparatus, equipment and facilities as said Lessee may deem necessary, requisite or desirable to the effectual exercise of all of the rights herein granted, including the right to locate, erect, construct, maintain and operate upon said land such derricks, machinery, tanks, reservoirs, sump holes, pipe lines, roads, telephone lines and structures and facilities of every kind or character that may be necess y, requisite, [58] desirable or auxiliary or incidental to the purposes for which said land is leased to said Lessee; also the right to develop, take and use such water as may be necessary or convenient for the carrying on of said business and operations and for pumping or transporting said substances or any of them from said property elsewhere; provided that, at the expiration of said term, April 17th, 1944, the said right to explore and drill for oil and other hydrocarbon substances shall terminate, but the Lessee may thereafter retain and operate all wells then producing, on the same terms as to royalty and other con-

Exhibit 3-C—(Continued)

ditions as are herein specified, and maintain and use such structures and equipment as may be necessary in the operation of such wells as long as such wells shall continue in use yielding oil or other substances in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save; and the Lessors hereby agree that as to any and all land surrendered by the Lessee at the termination of the Lessee's right to explore and drill, that no well shall be drilled upon said surrendered portions of the leased premises within two hundred (200) feet of the boundary line of the land retained or thereafter operated by the Lessee under the terms hereof. No implied covenants shall be read into this lease requiring the Lessee to drill or to continue drilling on said lands, or fixing the measure of diligence therefor.

3. As partial consideration of the rights herein granted to the Lessee, the Lessee agrees to pay to the Lessors, as their interests may appear for the privilege of drilling upon the demised property at the rate of Five Hundred Dollars ($500.00) per acre upon the execution of this lease by the said Lessors, and the Lessors agree to exhibit to the Lessee within ninety (90) days a certificate of title showing their ownership of the demised property free from encumbrances except as hereinbefore described, or if said property is otherwise encumbered, they shall furnish an agreement of the parties holding liens or mortgages thereon, consenting to [59] the making of this lease and subordinating

Exhibit 3-C—(Continued)

their rights to those granted by this lease. The Lessors hereby warrant and each agrees to defend her title to the land herein described.

[Marginal note]: $80,000 for [illegible] this land

4. The Lessee also further agrees in case Lessee shall find oil on the demised premises in quantities deemed by it sufficient to pay to pump or otherwise secure and save, to pay to the Lessors Five Hundred Dollars ($500.00) bonus per acre in oil, the same to be paid monthly at the rate of one-sixth of the value of the net production produced and saved on the demised premises in addition to the one-sixth primary royalty hereinafter provided, until said Five Hundred Dollars ($500.00) per acre in oil shall have been paid, after which only the one-sixth primary royalty shall be paid. Provided further that if the Lessee shall quit-claim the demised premises or surrender or forfeit this lease, or if the wells drilled on said land shall become exhausted, or if the Lessee shall elect not to operate the said wells, before said oil bonus has been fully paid, the Lessee shall not be required to pay, or be liable to the Lessors for all or any portion of said oil bonus then remaining unpaid.

[Marginal note]: no added oil bonus

5. The Lessee agrees to commence the drilling of a well for oil on the demised lands herein described when either of the following conditions shall first exist.

[Marginal note]: 3 strings drill within sixty days

Exhibit 3-C—(Continued)

(a) Within 90 days after oil shall have been produced in paying quantities in any well drilled within three hundred (300) feet of the demised premises, or

(b) Within two years from the date hereof,

6. Whenever the Lessee has commenced the drilling of a well for oil upon the demised premises thereafter the Lessee shall prosecute the drilling of such well with reasonable diligence (strikes, lock-outs, acts of God, unavoidable accidents or other interferences not within the control of the Lessee excepted) until it shall have encountered oil therein in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save, or until said well has been drilled to a depth at which it [60] is deemed by the Lessee practical to abandon the well.

7. In the event the Lessee shall drill said first well and shall not find oil therein in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save, then, as a condition of the continuance of the rights granted it under this lease, the Lessee will, within ninety (90) days after the abandonment of said first well commence the drilling of a second well and shall prosecute the drilling of said second well with reasonable diligence until oil is found therein in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save or until said second well has been drilled to a depth at which it is deemed by the Lessee practical to abandon the well.

8. Should oil not be found in said second well

Exhibit 3-C—(Continued)

in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save, the Lessee shall, within ninety (90) days after the abandonment of said second well, as a similar condition of the continuance of the rights hereunder, continue the drilling of additional consecutive wells and shall prosecute the drilling of each consecutive well with reasonable diligence until oil is found therein in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save, or until such consecutive well shall have been drilled to a depth at which it is deemed by the Lessee practical to abandon the well.

9. If oil is found in any of such wells in quantities deemed by the Lessee sufficient to pay to pump or otherwise secure and save, the Lessee may retain the drilling rights herein granted if it shall thereafter with due diligence and in good faith continue the drilling of wells upon said leased premises in the manner hereinabove provided, until it has drilled one (1) well for each ten (10) acres of land, or a total of ten wells. For that purpose, the Lessee must keep two strings of tools in operation, except on the last well, until it shall have drilled the [61] property retained by it at the rate of one well for each ten acres of land retained by it, but so long as the Lessee is not in default under the terms hereof, it may drill as many addifional wells on the leased premises retained by it as it may see fit, provided said wells are begun in good faith before the 17th day of April, 1944.

Exhibit 3-C—(Continued)

[Marginal note]: 3 strings.

10. It is expressly understood and agreed, however, between the parties hereto, that the Lessee may at its election at any time after the completion or abandonment of the first well, or any subsequent well or wells, cease further drilling, and whenever during the term of this lease and before all of the wells required hereunder are drilled, the Lessee shall elect that it will not complete the drilling requirements of this lease at the rate of one well to each ten acres of land; then and in that event, within ninety (90) days after Lessee makes such election, the Lessee shall release to the Lessors all such portion or portions of the demised premises except five (5) acres surrounding each producing or drilling well, and the Lessee shall remove from such portion or portions of the demised premises that it has so determined to release, all structures, appliances, apparatus, equipment and facilities which it has placed thereon; reserving however, to the Lessee, the right during the life of this lease, to maintain upon, under and across the land so released, such storage tanks, facilities, pipe lines and conduits as may have been constructed for the storing, handling and transporting of all oil or gas or water, under the terms of this lease, and to maintain over and across the land so released, such electric and telephone lines and roads as may have been constructed for use in connection with operations on the demised premises. The Lessee may hold each of said five acre tracts, so retained by it,

Exhibit 3-C—(Continued)

free of further drilling obligations so long as oil or gas is produced from the well thereon. Each said five acre tract shall be in [62] the form of a square or rectangle, the longer side of which shall not exceed more than twice the length of the shorter side.

11. After having discovered oil in paying quantities at any depth in any well drilled by it, the Lessee may, should it so desire, drill to an additional depth in such well or wells to explore for oil in greater or additional quantities.

12. The Lessee shall also have the right to do such acts and things as may be necessary to keep said wells in the highest productive state, including the right to ream, clean out, deepen, or redrill within a radius of fifty (50) feet of any producing well, in order to maintain or increase the production.

13. The Lessee further agrees that, in the event any wells producing oil in paying quantities shall be brought in during the life of this lease on land adjacent to said premises within one hundred fifty (150) feet of the boundaries of said demised premises, whether by itself or any person or corporation, which adjacent territory shall not be at the time the property of the Lessors, said Lessee in drilling wells under the terms of this agreement, shall attempt to locate wells on the premises of the Lessors in such manner as to best offset wells which may have been brought in on adjacent territory and thereby, as far as possible, prevent the Lessor's

Exhibit 3-C—(Continued)

land from being drained by such operation on such adjacent territory. It is understood, however, that Lessee shall not be required to drill more than (1) well for each ten (10) acres of land of the leased premises retained by it nor to keep more than two (2) strings of tools in operation hereunder after it shall have begun drilling as hereinabove agreed.

[Marginal note]: raise to 4

14. It is expressly understood and agreed between the parties hereto, that, for the purposes of this lease, a well producing oil in paying quantities shall be understood and considered a flowing or pumping well, which if two thousand (2000) feet or shallower in depth, shall produce an average of one hundred [63] (100) barrels per day for thirty (30) consecutive days immediately following completion, and if deeper than two thousand (2000) feet, shall produce an average of 200 (two hundred) barrels per day for thirty (30) consecutive days immediately following completion.

15. If, at any time the price of oil of a gravity of 14° Baume, or of any higher gravity, at 60° Fahrenheit, shall fall below sixty ~~(60)~~ 70 cents a barrel at the wells, Lessee may cease producing (pumping or flowing) oil, or drilling wells, upon said demised premises for and during the time that the said price of oil shall remain below sixty ~~(60)~~ 70 cents a barrel at the wells, and the cessation of such pumping or drilling during such time shall not have the effect

Exhibit 3-C—(Continued)

of terminating this lease, or any of the rights herein granted to the Lessee.

16. The Lessee agrees to keep an accurate log and casing record, showing the progress of drilling and casing in each well in which drilling shall have been done on the demised premises, and to give the Lessors access to such log and casing record at all reasonable times and at such times to permit the Lessors to inspect such log and casing record and to make a copy thereof.

The Lessee further agrees to keep a record of installation of all pipe lines laid by the Lessee on the demised premises showing the location of such pipe lines, and to give the Lessors access to such record at all reasonable times, and at such times to permit the Lessors to inspect such record and make a copy thereof. The Lessee further agrees that the top of all pipe lines laid on any portion of the demised premises shall be not less than eighteen (18) inches below the surface of the ground at all points (when so requested in writing by the owner of the land) and said request may be made at any time.

17. The Lessee also agrees to keep the demised premises and every part thereof free from liens for work or labor done for or materials or supplies furnished to Lessee during its occupancy [64] of the demised premises, or any part thereof, to cause same to be released or discharged of record; provided that, if Lessee shall dispute the justice of any such claim or claims, it shall have the right to defend against the same, and in the event that Lessee

Exhibit 3-C—(Continued)

shall fail or refuse to defend any action brought to enforce any such claim or claims, the Lessors shall have the right to defend against the same and the Lessee shall be liable to the Lessors for all costs, damages and counsel fees reasonably expended by Lessors in defending any such action and for the payment of any final judgment entered against Lessors, and that Lessors shall have the privilege at all times of posting and maintaining upon the property used by the Lessee, notices that the Lessors are not responsible for any debts contracted by the Lessee.

18. The Lessee further agrees to prevent as far as practicable with the exercise of reasonable care and diligence the overflow of oil or water which may be detrimental to vegetable growth upon the portions of the demised premises which are suitable for agricultural or horticultural or any other purpose and to save the Lessors harmless from all damages and claims for damages for preventable injuries to adjacent lands, caused by the overflow of such oil or water.

19. The use by the Lessors of any portion of the demised premises for agricultural or horticultural or other purposes shall however, be at the risk of the Lessors, and the Lessee shall not be liable for any injury to the demised premises or anything grown or growing thereon, except insofar as any such injury shall be proximately caused by the Lessee's failure to exercise reasonable care and diligence hereinabove agreed to be exercised by it. In

Exhibit 3-C—(Continued)

the event of inability of the parties to agree as to the amount of any such damage, such amount shall be determined by arbitration, one arbitrator to be selected by the Lessors, one by the Lessee, and, if the two so selected shall [65] be unable to agree, they shall select a third arbitrator. The decision of a majority of said three arbitrators shall be binding on the parties.

20. In the event that the Lessee shall develop water on the demised premises in excess of the quantity which the Lessee may deem necessary for its use, the Lessors shall have the right to use any such excess water for irrigation purposes upon any portion of the demised premises which may be put to agricultural or horticultural uses hereunder; provided, however that the Lessors shall bear and pay all costs and expenses incident to the diversion of such excess water for irrigation purposes, and that Lessors shall use excess water entirely at their own risk and that such excess water shall be so diverted and used as not to interfere with or interrupt the operations of the Lessee on the demised premises.

21. All of said hydrocarbon substances shall be collected in tanks, reservoirs, or sumps upon the demised premises or upon property convenient thereto, which tanks, reservoirs and sumps shall be built and maintained at the expense of the Lessee. Nothing herein contained shall require the Lessee to segregate or keep separate the various grades of oil produced upon the demised premises, nor shall

Exhibit 3-C—(Continued).

the Lessee be required to keep separately the production of any well or group of wells. The oil so produced and saved from the different wells may be commingled, and after such commingling, shall represent the character of oil produced upon the demised premises. The Lessee shall account and settle therefor, both as to quantity and quality, as measured and determined at its shipping tanks on the demised premises.

22. As a further consideration of this agreement, the Lessee agrees to pay to the Lessors a primary royalty of one-sixth (one-sixth) of the net amount of all petroleum, oil, naptha and other hydrocarbon substances which may be produced and saved [66] from the demised premises, after deducting from the gross product the quantity that may be consumed in the development and operation of said property while any of said substances are being produced from said premises and in pumping or transporting any of said products from said property elsewhere. The Lessee shall also pay one-sixth (1/6th) of the proceeds from the sale of all gas produced and sold on the demised premises to the Lessors; the payment of said one-sixth (1/6th) of said proceeds to be made on the twentieth (20th) day of each calendar month out of the proceeds realized from the sale of gas during the last preceding calendar month.

The Lessee shall have the right to contract for the manufacture of casing-head gasoline from gas produced on the demised premises provided that

Exhibit 3-C—(Continued)

said contract shall not allow more than sixty-five (65%) percent to the party manufacturing said gasoline and shall reserve not less than thirty-five (35%) percent of said gasoline to be divided between the parties hereto on the basis of one-sixth (1/6th) to the Lessors and five-sixths (5/6ths) to the Lessee.

23. The Lessors reserve, and the Lessee agrees to render and pay unto the Lessors, an additional or secondary royalty which shall become payable and shall be ascertainable as follows: [67]

An accurate account shall be kept by the Lessee of the expenses of its development work and other operations upon said land from the time of the commencement of such work. Said account shall include, but not be limited by the following items:

(a) The sum of $50,500.00 which the Lessee has paid the Lessors as a cash bonus for the execution of this lease.

[Marginal note]: 130500

(b) The sum of $50,500.00 which the Lessee herein agrees to pay as oil bonus to the Lessors. Said sum shall be entered in this account when and as the oil bonus is paid to the Lessors.

[Marginal note]: same

(c) The primary royalty provided to be paid to the Lessors under the terms of this lease, and any other royalties, rents or sums to be paid under said lease or any modification thereof, which may be made between the parties hereto.

Exhibit 3-C—(Continued)

(d) Sums sufficient to meet all state and county taxes upon the said premises or the mineral rights therein, other than those borne by the Lessors under the terms of this lease; assessments for the oil production fund of the State Oil and Gas Supervisor; and any other assessment, tax or levy, other than those provided to be borne by the Lessors, which may be required to be paid by the Lessee on the oil produced and its products; or on the demised premises; or on the equipment used in operating said premises; or as a result of the operations of the Lessee under the terms of this lease.

(e) Any rentals that may be paid to the Lessors. Payments made or to be made for all damages resulting from the operations of the Lessee on the demised premises. Any other payments of any kind whatsoever made or to be made by the Lessee in connection with operations upon said lands, and/or under the terms of this lease or any modifications thereof.

(f) The cost to the Lessee of all expenditures made for developing and operating said premises, and the cost to the Lessee of equipment purchased to be installed for use on said premises in [68] operating the same, together with overhead expenses and expenses for the use of facilities and any other expenditures determined in the manner hereinafter described for current overhead; for use of facilities in current operations and for any other expenditures. Current operating cost of operating said wells, including the cost of producing all royalty products.

Exhibit 3-C—(Continued)

(g) Such pro-rata share of Lessee's current overhead as shall be arrived at by pro-rating each month the total overhead expenses of the Lessee on the same basis on which the Lessee apportions overhead through its regular accounting system, to all leases operated by it.

(h) A fair and equitable proportional charge for the use of facilities used by the Lessee on or in connection with its operations on said premises, jointly with its operations on other land, either leased or owned by the Lessee.

(i) Any expenditures made or obligations incurred for insurance or matters of like character.

(j) Any other expenses incurred or expenditures made in good faith in connection with or arising out of the development work and operations of the Lessee.

All charges determined in the foregoing manner shall be known as "Operating Charges."

The Lessee shall also keep an accurate account of all oil produced and saved on the demised premises, as determined at its shipping tanks as herein provided, the value of material removed from the demised premises and all other revenue derived from its operations on the demised premises. The value of the oil shall be determined at the prevailing market price as herein provided. The value of the gasoline shall be determined at the contract price at which gasoline produced on the demised premises is sold by the party making said gasoline. The

Exhibit 3-C—(Continued)

foregoing items shall be known as "Income Credits." [69]

Material, supplies and equipment that may be furnished by the Lessee itself for use on the demised premises shall be charged at landed cost except that second-hand or used material shall be charged at its depreciated value arrived at by using the Lessee's established method and rate of depreciation for like materials as shown in its regular accounts. In case such depreciated value is not ascertainable as to any article or articles the fair and reasonable value shall be charged. Upon the subsequent removal or disposition of any such supplies, materials, or equipment, the depreciated value thereof at the time of such removal or disposal determined in the same manner shall be credited and treated as part of the "Income Credits".

When, and as soon as the "Income Credits" of said account shall exceed the "Operating Charges" of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the "Operating Charges and "Income Credits" of said account.

24. Said primary royalty shall always be paid unto the Lessors, and payment of said secondary royalty, computed as aforesaid, in addition thereto, shall be made each month, when such account shows a profit or surplus.

25. The Lessors agree to sell unto the Lessee, and the Lessee agrees to purchase from the Lessors,

Exhibit 3-C—(Continued)

all primary and secondary royalty at the prevailing market price thereof, in the oil field in which the demised land is situated.

Each one-third unit of the rents and royalty payable under this lease or any modification thereof to each one of the Lessors, as provided in Paragraph 28, shall always be treated as a single unit and if the Lessors shall sell or otherwise dispose of any interest, in whole or in part, of said royalty unit, or if the same shall become the property of others then the said Lessor, said one-third unit of the royalty shall always be treated as a single unit and pay- [70] ment therefor shall be made by the Lessee as a single unit to the Lessor or to an agent designated by her.

26. The prevailing market price hereinabove referred to shall be the market price at the well prevailing from time to time when the royalty oil would be deliverable hereunder if some were not purchased by the Lessee, for oil produced in the oil field, in which the demised premises are situated, of similar gravity or gravities as that produced from the demised premises, provided that whenever such market price shall vary during any calendar month, then the price to be paid for the royalty oil purchased by the Lessee during such month shall be based on the average daily quantity purchased by the Lessee during such month; that is to say, payment for royalty oil purchased during such month shall be at the respective prices, effective during such month for such proportion of the total amount

Exhibit 3-C—(Continued)

of royalty oil purchased by the Lessee during such month as the number of days such price remains effective during such month bears to the total number of days in such month.

27. The Lessee agrees that it will, on or before the 20th day of each calendar month, furnish to the Lessors, a true account of the production of all substances herein named from the demised premises during the next preceding calendar month, except such portion thereof as may be used in the development and operation of the property under the terms of this lease.

As soon as the operations of the Lessee upon the demised premises shall show a surplus in the account provided for in paragraph 23, the Lessee shall render on the 20th day of each and every calendar month to the Lessors, a statement showing the "Operating Charges" and "Income Credits" in connection with the demised premises for the preceding period or calendar month, which statement shall be in the same form as that prepared by the Lessee for its own use.

28. The Lessee agrees to make payment to the Lessors [71] on the 20th day of each calendar month for all royalties due the Lessors during the preceding calendar month. The Lessee shall pay all amounts due first parties under this agreement as follows: One-third (1/3d) to Florence Vickers McAllister; one-third (1/3d) to Anna Vickers Crawford; one-third (1/3d) to Clara Vickers Naftzger.

Exhibit 3-C—(Continued)

Such payments shall be made to the parties at 1001 Story Building, Los Angeles, California, or second party may, at its option, deposit the same to the credit of the first parties in the Pacific Southwest Trust & Savings Bank, Sixth and Spring Streets, Los Angeles, California, its successors and any bank or trust company with which it may become merged or which may acquire its banking business. If said Bank shall at any time refuse to receive said payments for the Lessors and the Lessors shall fail to select another Bank within fifteen days of said refusal by said Bank, then the Lessee shall have the right to designate any Bank to receive said payments for said Lessors. The Lessee shall thereupon notify the Lessors of the designation of said Bank and said Bank shall so continue to receive said payments for the Lessors until the Lessors shall select another Bank as herein provided.

29. The Lessors shall have the right, if they so desire to inspect Lessee's records at any time during business hours for the purpose of verifying such accounts and the right to measure and gauge the quantity of any and all of said substances produced on said premises, such right to be exercised during business hours only.

30. The Lessee agrees to occupy no more land than is reasonably required for the drilling of wells and for the operation of any and all wells drilled hereunder, and for such structures, appliances, appurtenances, equipment and facilities as may [72] be necessary or desirable for the effectual exercise

Exhibit 3-C—(Continued)

of the rights herein granted to Lessee, but it is understood that this provision shall not operate as a limitation upon the number of wells which may be drilled by the Lessee or so as to interfere in any manner with the effectual exercise by the Lessee of all the rights granted to it hereunder.

31. Should any well be drilled and no oil be produced therefrom, or when a producing well becomes non-productive, the Lessee shall have the right to abandon such well and to remove all casing therein, but shall restore the ground to a safe condition by leveling to its original contour as near as practicable.

32. If the Lessee shall drill any well upon the demised premises which shall prove to be a water well and not an oil well and the Lessee shall desire to abandon such well as an oil well and the owner of said parcel of land on which such well is located shall desire to acquire the same as a water well, such owner shall pay to the Lessee the market price of the casing in said water well prevailing at the time of purchase thereof by such owner, and if the owner shall not desire to acquire such water well and purchase such casing, the Lessee shall have the right to pull and remove the casing therefrom. And whenever the Lessee shall desire to abandon a water well, it shall notify the owner of the parcel of land upon which said well is located, in writing, of its desire so to do, and if the owner of such land shall fail, within twenty (20) days after the receipt of such notice, to elect to retain said well and pay for the

Exhibit 3-C—(Continued)

casing therein the Lessee shall be at liberty to pull and remove said casing from such well at any time after the expiration of said twenty (20) days.

33. The Lessee will comply with all laws of the State of California in its operations under this lease.

34. For the purpose of this lease, no structure, appliances, apparatus, equipment or facility placed by Lessee upon [73] or in the demised premises shall be deemed to be a fixture, but all thereof shall belong to the Lessee subject to the provisions relative secondary royalty as herein provided and the Lessee shall have the right at any time prior to the expiration of ninety (90) days after the termination of this lease, to remove from the demised premises all structures, appliances, apparatus, equipment, facilities and materials, including casing in all wells.

35. The Lessee shall pay, before same become delinquent all taxes that may be levied against its improvements, machinery, and personal property on the demised premises, including any oil and minerals belonging to the Lessee that may be stored on said premises, and if the assessed valuation of the said demised premises shall be increased over and above the amount at which said premises were assessed for the present fiscal year (1924-1925) and such increase shall be due to the operations of the Lessee on said premises and/or the minerals or mineral rights of said premises. Lessee shall pay five-

Exhibit 3-C—(Continued)

sixths (5/6ths) of the taxes upon such increase or if the minerals and mineral rights shall be separately assessed either to the Lessee or the Lessors, the Lessee shall pay five-sixths (5/6ths) of all taxes assessed against said minerals and mineral rights. Subject to the foregoing provisions, the Lessors agree to pay all taxes assessed against said premises, including one-sixth (1/6th) of the taxes due to the operations of the Lessee on said premises, or minerals or mineral rights therein, whether the same are shown in an increase in the valuation of the property or the minerals and mineral rights are separately assessed.

The Lessee in every event is hereby authorized to pay the one-sixth (1/6th) of the taxes which the said Lessors do herein agree to pay, and in such event the said Lessee may deduct the same amount paid as taxes for the Lessors from the royalties which shall become due or owing the Lessors hereunder. Either [74] party may pay the entire amount of any tax which shall constitute a lien against the demised premises and shall be entitled to reimbursement from the other party of the part thereof herein agreed to be paid by such party with interest thereon at the rate of six (6%) percent per annum from and after the date upon which demand for such reimbursement shall have been made until paid.

36. The Lessee shall have and reserves the right at any time to surrender this lease and all or any portion of the leased premises and by such surren-

Exhibit 3-C—(Continued)

der and the execution of a quit-claim deed, the Lessee shall be released from all further drilling obligations as to such surrendered land. The Lessee may elect to stop further drilling at any time. In the event the Lessee elects to stop further drilling before a producing well is completed on the demised premises, then within ninety (90) days thereafter, the Lessee shall release, quitclaim and surrender to the Lessor all of its right, title and interest in and to the demised premises, subject to such reservations and in the manner herein provided.

37. Upon the termination of all of the Lessee's rights under this lease, the title to all unsevered petroleum, oil, natural gas, and other hydrocarbon substances lying in and under the demised premises shall revert to the respective owners thereof, and the Lessee agrees thereupon and upon demand of such owners to execute and deliver to the said owners an instrument quitclaiming to the said owners all interest of the Lessee in the demised premises so as to effectually clear the title of said premises from any interest of the Lessee under this lease.

Upon the expiration, forfeiture or termination from any cause of this lease, as to the said demised premises, or any portion thereof, the Lessee shall be under the obligation promptly to execute and deliver to the Lessors a good and sufficient quitclaim deed or other instrument in proper form to be recorded and clear the record title of said premises, or the portion thereof as to [75] which the lease has

Exhibit 3-C—(Continued)

terminated, of the cloud created thereon by the recording of this lease, or of any notice thereof.

38. Should any dispute arise between the parties hereto concerning the interpretation of any term used herein or the effect or meaning of any of the provisions hereof, or as to any matter of fact affecting the rights of the parties hereto, such dispute shall be submitted to and decided by three arbitrators, one to be appointed by the Lessee, one by a majority in area of the Lessors, and a third by the two so appointed, and the decision of a majority of such Board shall be binding upon the parties hereto.

39. If the Lessee shall fail, for a period of ninety (90) days after written notice is given to it by the Lessors to comply with any provision of this lease, the majority in area of the Lessors may, at their option, terminate this lease, or the owner of any tract of land, may terminate this lease as to said tract, provided that no failure on the part of the Lessee to comply with any of the provisions of this lease as to any well or wells on any parcel of five (5) acres surrounding same shall affect the rights of the Lessee to continue its possession or operation of any other well or wells situated on any other five (5) acre parcel or parcels.

40. Failure on the part of the Lessee to comply with any provision or condition of this agreement by reason of accident or delay caused by fire, the elements, act of God, strikes, lockouts, war, insurrection, rebellion, or by interruption of transportation

Exhibit 3-C—(Continued)

facilities or by Governmental action or by any cause beyond the control of the Lessee, whether similar to the causes herein specified or not, shall not be deemed as a failure by Lessee to comply with any provision of this lease, or a violation of any of the provisions in this lease contained. [76]

41. All the terms and conditions hereof shall bind and benefit the heirs, executors, administrators, successors and assigns of the respective parties hereto and an acceptance of any interest in this lease by any person shall be construed as a promise on his part to be bound by and perform all the covenants herein contained and entered into by the person or persons whose rights he has acquired.

42. Upon the making of any assignments of this lease or of any interest therein, a copy of such assignment and of any contract relating to the same shall be delivered to the Lessee and no such assignment shall be effective unless the said copy is so delivered to and filed with the said Lessee.

43. The Lessee is further granted the right to use and enjoy the necessary rights of way for ingress and egress into, upon, and across that certain real property, situate in the County of Los Angeles, described as follows:

The 417.330195 acre tract of land in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramona S. de Machado, by the final decree of partition of a portion of said Rancho had in Case No. 2722, of the District Court and

Exhibit 3-C—(Continued)

shown on Map recorded in Book 3, Page 204, et seq., Miscellaneous Records of said County, described as follows, to-wit:

Commencing at Station 1 of the Patent Survey of said Rancho, thence South Twenty and one-half Degrees East (S 20½° E) One Hundred and Seven and Seventy-nine hundredths (107.79) chains to Station 2, thence South Forty-Eight and one-half Degrees West (S 48½° W) Three and Five Hundredths (3.05) chains; thence North Eighty and Three-fourths Degrees West (N 80¾° W) Seventy-nine and Thirty-eight Hundredths (79.38) chains to the Easterly line of Flower Street, thence along said Easterly line, North ten and one-half Degrees West (N 10½° W) one and Three Hundredths (1.03) chains; thence North Twenty-one Degrees East (N 21° E) Forty-seven and Forty-six Hundredths (47.46) chains, thence North Thirty-one and one-half degrees East (N 31½° E) fifty and Fifty hundredths (50.50) chains to point of beginning; Excepting therefrom the land described as follows, to-wit:

Commencing at Station 1 of said Four Hundred and Seventeen and Thirty-three Hundredths (417.33) acre Tract, thence along the Easterly boundary line of said above mentioned tract, a distance of Three Hundred and Thirty-two and Eighty Hundredths (332.80) feet to a point in said Easterly boundary line, a stake; thence [77] South Eighty-six Degrees, Fifteen Minutes (S 86° 15'W) Three hundred and Twelve and Seventy-eight Hundredths

Exhibit 3-C—(Continued)

(312.78) feet to the Westerly boundary line of said Four Hundred Seventeen and Thirty-three Hundredths (417.33) acre tract; thence along the Westerly boundary line of said Tract Three Hundred Eighty-four and Fifty Hundredths (384.50) feet to the place of beginning, being One and Fourteen Hundredths (1.14) acres more or less, conveyed to Harry D. Brown, Jr., by deed dated January 17th, 1919, recorded in Book 6795, Page 85 of Deeds.

Beginning at the intersection of the North line of Lot Nineteen (19) of that subdivision of the Southern portion of the Rancho Rincon de Los Bueyes, recorded in Book 53, Page 25 of Miscellaneous Records of the County of Los Angeles, California, with the East line of that certain Four Hundred Seventeen and Thirty-three Hundredths (417.33) acre tract of land in the Rancho La Ballona, County of Los Angeles, State of California, allotted to Ramon S de Machado by the Final Decree of Partition of a portion of said Rancho had in the Case No. 2722, of the District Court and shown on Map recorded in Book 3, Page 204, Miscellaneous Records of said County; thence running South Twenty Degrees, Thirty Minutes (20° 30') East a distance of Nine Hundred Forty-one and Eight tenths (941.8) feet to a point; thence South Sixty-nine Degrees, Thirty minutes (69°30') West for distance of Two Hundred (200) feet to a point; thence North Twenty Degrees, Thirty Minutes (20°30') west to a distance of Nine Hundred Forty-one and Eight Tenths (941.8) feet to a point,

Exhibit 3-C—(Continued)

thence North Sixty-nine Degrees, Thirty Minutes (69°30′) East a distance of Two Hundred (200) feet to the place of beginning, containing Four and Three Hundred Twenty-four Thousandths (4.324) acres, more or less, conveyed to Charles W. Rand, by deed dated January 21st, 1918, recorded in Book 6606, Page 342 of Deeds.

together with the right to construct, maintain, use and enjoy pipe lines, power and light lines and roads, constructed by it, and roads that are now, or may hereafter be built on the lands described in this section, provided however, that the rights of way herein granted shall be subject and subordinate to, and shall not interfere with the rights which the Lessors have granted or may grant in any lease for oil development purposes. If the Lessee herein shall use any road constructed by others, it shall pay a proportionate and equitable share of the cost of maintaining said road, and in a like manner, if the Lessee herein shall construct any road, and the Lessors shall grant the right to use said road to other parties, the grantee [78] of such rights shall pay the Lessee herein a proportionate and equitable part of the cost of maintaining said road. All roads shall adapt themselves so far as practicable to the present and subsequent uses of the land by the owner. For example, if any of the land shall be surrendered and subsequently subdivided, the company shall use any roads or streets made in such subdivision for such uses as practicable, and any road used by the company shall be located where

Exhibit 3-C—(Continued)

they shall be least detrimental to the use of said leased lands permitted to the owner consistent with the purposes for which this lease is given. Rights granted under this paragraph are subject to the remaining terms of this lesse.

44. In Witness Whereof, the individual Lessors have hereunto affixed their hands and the Lessee has caused these presents to be executed by its proper officers thereunto duly authorized and its corporate seal to be hereunto affixed the day and year first above written.

FLORENCE VICKERS McALLISTER
ANNA VICKERS CRAWFORD
CLARA VICKERS NAFTZGER

Lessee—
ASSOCIATED OIL COMPANY
[Seal] By A. C. McLAUGHLIN
Vice President
By J. P. EDWARDS
Asst. Secretary

State of California
County of Los Angeles—ss.

On this 22nd day of April, in the year nineteen hundred and Twenty-four A. D., before me, Florence E. Lea, a Notary Public in and for the said County of Los Angeles, State of California, residing therein, duly commissioned and sworn, personally appeared Florence Vickers McAllister, Anna

Exhibit 3-C—(Continued)

Vickers Crawford and Clara Vickers Naftzger, personally known to me to be the persons whose names are subscribed to the within instrument, and acknowledged to me that they executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal in said County the day and year in this certificate first above written.

[Seal] FLORENCE E. LEA

Notary Public in and for Los Angeles County, State of California [79]

The undersigned Frank A. McAllister, husband of Florence Vickers McAllister, one of the Lessors named in the foregoing instrument, hereby declares that the real property the subject thereof is the separate property of said Florence Vickers McAllister, and he assents to the lease evidenced by such instrument.

Dated April 25th, 1924.

FRANK A. McALLISTER

State of California

County of Los Angeles—ss.

On this 25th day of April, in the year nineteen hundred and twenty four, A. D., before me, W. S. Ackerman, a Notary Public in and for the said County of Los Angeles, State of California residing therein, duly commissioned and sworn, personally appeared Frank A. McAllister personally known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that he executed the same.

Exhibit 3-C—(Continued)

In Witness Whereof, I have hereunto set my hand and affixed my official seal the day and year in this certificate first above written.

[Seal] W. S. ACKERMAN
Notary Public in and for Los Angeles County, State of California

The undersigned Clarence H. Crawford, husband of Anna Vickers Crawford, one of the Lessors named in the foregoing instrument, hereby declares that the real property the subject thereof is the separate property of said Anna Vickers Crawford, and he assents to the lease evidenced by such instrument.

Dated April 22, 1924.

CLARENCE H. CRAWFORD

The undersigned Roy E. Naftzger, husband of Clara Vickers Naftzger, one of the Lessors named in the foregoing instrument, hereby declares that the real property the subject thereof is the separate property of said Clara Vickers Naftzger, and he assents to the lease evidenced by such instrument.

Dated April 22, 1924.

ROY E. NAFTZGER

State of California
County of Los Angeles—ss.

On this 22nd day of April, in the year nineteen hundred and Twenty-four A. D., before me, Florence E. Lea, a Notary Public in and for the said County of Los Angeles, State of California, resid-

Exhibit 3-C—(Continued)

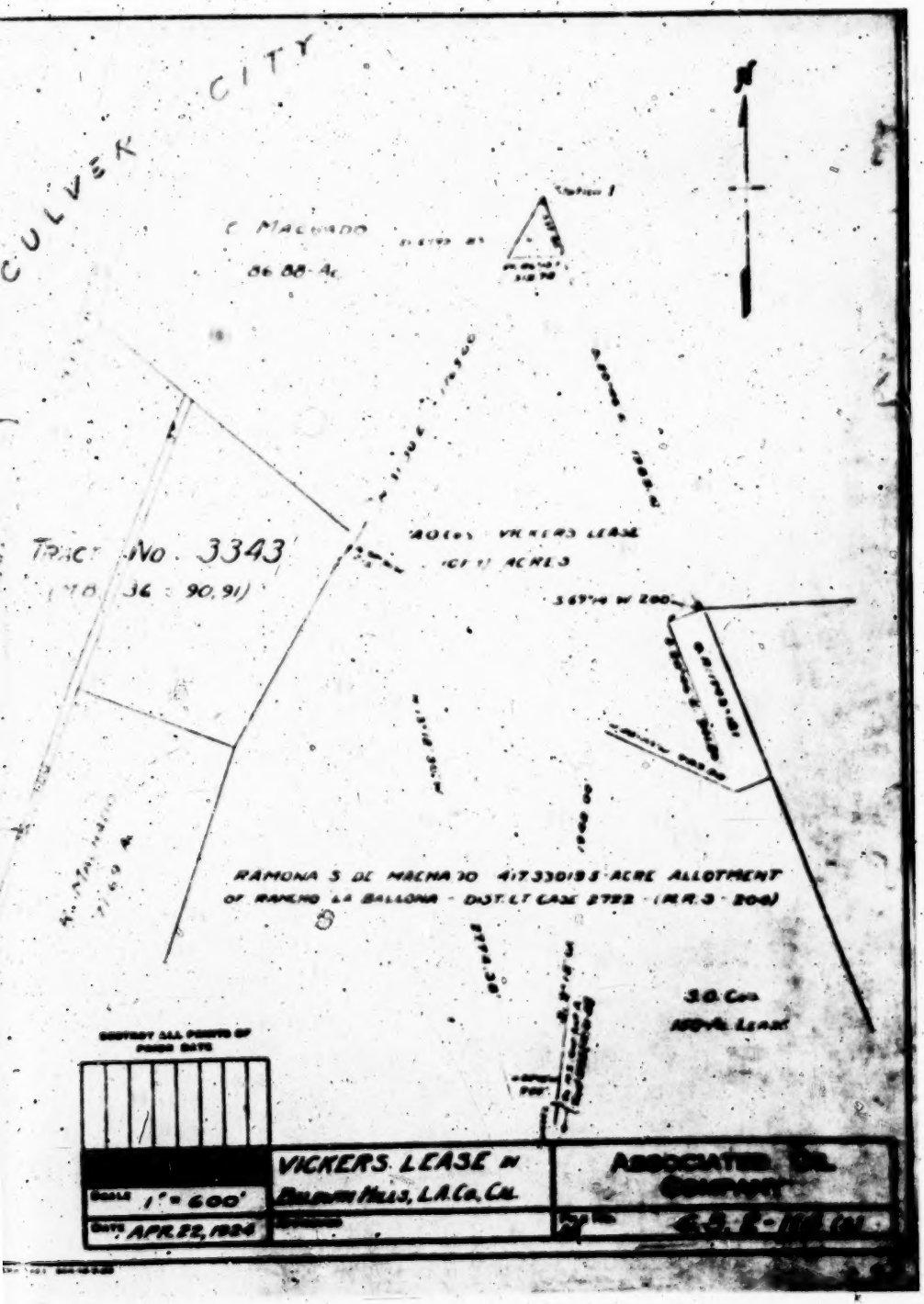
ing therein, duly commissioned and sworn personally appeared Clarence H. Crawford and Roy E. Naftzger, personally known to me to be the persons whose names are subscribed to the within instrument, and acknowledged to me that they executed the same.

In Witness Whereof, I have hereunto set my hand and affixed my official seal in said County the day and year in this certificate first above written.

[Seal] FLORENCE E. LEA,
Notary Public in and for Los Angeles County, State of California.

[Endorsed]: U.S.B.T.A. Filed Sept. 20, 1943.

[80]


CULVER CITY
C. MACHADO
86.88 AC.
TRACT NO. 3343
(M.B. 36 - 90, 91)
ADLER VICKERS LEASE
61.1 ACRES
RAMONA S DE MACHADO 417330195 ACRE ALLOTMENT
OF RANCHO LA BALLONA - DIST. LT CASE 2782 - (R.R. 3 - 206)
S.P. Co.
100 Yr. Lease
VICKERS LEASE IN
Ballona Hills, L.A. Co. Cal.
ASSOCIATED OIL COMPANY
SCALE 1" = 600'
DATE APR. 22, 1924

The Tax Court of the United States

Docket No. 111947

ANNA VICKERS CRAWFORD,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Sidney D. Krystal, Esq.,
for the petitioner.

Harold D. Thomas, Esq.,
for the respondent.

MEMORANDUM OPINION

Arnold, Judge: This proceeding involves income tax deficiencies for 1938, 1939 and 1940, in the respective amounts of $18,018.01, $16,361.57 and $17,339.48. All issues have been settled by agreement of the parties except one common to each of the taxable years, namely, whether petitioner is entitled to percentage depletion on alleged oil royalties of $26,462.50, $23,921.75 and $21,997.34 for the years 1938, 1939 and 1940, respectively.

The stipulated facts are adopted as our findings of fact. Only such facts as are necessary for an understanding of the issue will be hereinafter set forth. [82]

Petitioner is an individual residing in Los Angeles, California. Her income tax returns for each of the taxable years were filed with the collector of internal revenue for the sixth district of California.

At all times herein mentioned petitioner owned an undivided one-third interest in and to certain property situated in the County of Los Angeles, California, known as Rancho La Ballona, a tract of land of 417.330195 acres. On or about April 12, 1924, petitioner, together with Florence Vickers McAllister and Clara Vickers Naftzger, each the owner of an undivided one-third interest as her separate property, as lessors, executed a lease with Standard Oil Company, a California corporation, for the drilling of oil on a portion of the Rancho La Ballona property. The lease covered 150 acres more or less, and recited that the individuals, as first parties, desired to enter into an arrangement with the Standard Oil Company, as second party, whereby Standard "shall develop and operate the said above described real property for oil, gas, asphaltum and other hydrocarbon substances, in accordance with all of the terms and conditions herein set forth * * *." The lease indenture then set forth the mutual covenants and agreements of the parties, which provided, inter alia, for exclusive drilling and operating rights in Standard for the term of two years and so long thereafter as Standard conducted drilling operations thereon and as long as oil, gas, asphaltum or other hydrocarbons were produced in paying quantities. Standard was to pay $75,000 with the execution of the lease and agreed to commence the drilling of a well on the premises within two years and to prosecute the same with reasonable diligence until oil was found in paying quantities. At any [83] time within the two years Stand-

ard could terminate the lease and surrender the premises provided, however, that if during the first 21 months of the lease oil was discovered on specified property, situated east and southeast of the lease premises Standard would, within three months after such discovery, commence the drilling of a well, or terminate the lease. Standard agreed to pay $10 per month per acre, or terminate the agreement, if it had not commenced the drilling of a well within a year after execution of the lease indenture. If Standard failed to obtain oil in paying quantities in its first well, it was required to commence drilling another well within 90 days in order to retain its rights under the lease indenture. If oil was found in paying quantities additional wells were to be drilled as rapidly as at least two strings of tools working with due diligence could complete the wells. After completion of the first or any subsequent well Standard could cease further drillings, surrender the premises and terminate the agreement as to all the premises, except as to 10 acres around each producing or drilling well which could be held free of further drilling obligations as long as oil or gas was produced therefrom. Standard agreed to commence drilling offset wells within 90 days after discovery of oil within 250 feet of boundary lines of leased premises. All labor and materials were to be furnished by Standard and first parties were not chargeable with nor liable for any part thereof. Standard agreed to pay all damages directly occasioned by operations to grow-

ing crops, and in case of dispute as to the amount thereof, arbitration was provided for. The terms "gross proceeds", "sale value", "chargeable expenses" and "net profits" were [84] defined by the lease indenture. Standard was required to keep true and correct books of account and deliver a monthly itemized statement to first parties showing production, "gross proceeds" and "chargeable expenses." Each month, Standard was to account and pay to first parties, under paragraph 31 of the lease, as follows:

A. As a minimum:

(1) a sum representing the "sale value" as herein defined of the one-fifth (1/5th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.

(2) One-fifth (1/5th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.

B. Such sum, if any, in addition, as shall represent the amount by which one-half (1/2) of the "net profits" derived from the operations on said property up to the end of such calendar month shall exceed the aggregate of—

(1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus

(2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

Standard was to pay all amounts due first parties under the lease, one-third to each of said first parties. If Standard failed for 90 days after written notice to comply with any provisions of the agreement first parties could, at their option, terminate the agreement, except that default as to any well or wells should not affect Standard's operation of any other well or wells situated in any other 10 acre parcel.

On or about January 6, 1925, the same parties executed a lease for the drilling of oil on another portion of the Rancho La Ballona property. This lease covered 80 acres, more or less, was for a term of five years [85] and so long thereafter as oil, gas, etc., were produced in paying quantities unless otherwise surrendered or forfeited by Standard. The provisions of the lease are substantially the same as the provisions of the first lease between the parties. The consideration was different in that $80,000 was paid by Standard with the execution of the lease and the minimum monthly sum to be paid first parties under paragraph 31 A of the January 6, 1925, lease was one-sixth (1/6th) of all oil, etc., and one-sixth (1/6th) of the actual proceeds of all gas produced, saved and sold. Paragraph 31 B of this lease is identical with paragraph 31 B of the lease of April 12, 1924, between the same parties.

On or about April 18, 1924, Anna Vickers Crawford, Florence Vickers McAllister and Clara Vickers Naftzger, as lessors, executed a lease with Associated Oil Company, a California corporation, for the drilling of oil on another portion of the Rancho

La Ballona property. This lease covered 101 acres, more or less, and was for a term of 20 years. It provided for the payment to the lessors of a cash bonus of $50,500; an oil bonus of $50,500 payable only out of net production, paragraph 4 of the lease; "a primary royalty of one-sixth (1/6th) of the net amount of all petroleum, oil, naphtha and other hydrocarbon substances which may be produced and saved from the demised premises, after deducting from the gross product the quantity that may be consumed in the development and operation of said property * * *", paragraph 22 of the lease; and one-sixth of the "proceeds from the sale of all gas produced and sold on the demised premises", paragraph 22 of the lease. The lessee was authorized to contract for the manufacture of casing-head gasoline, provided, [86] at least 35 per cent of said gasoline was reserved to be divided between the lessors and lessee on the basis of one-sixth and five-sixths, respectively, paragraph 22 of the lease.

By paragraph 23 of the lease indenture the lessors reserved and the lessee agreed to render and pay unto the lessors "an additional or secondary royalty which shall become payable and shall be ascertainable as follows * * *." After providing in detail for all charges which should be known as "Operating Charges" and for all items that should be known as "Income Credits", paragraph 23 then provided as follows:

> When, and as soon as the "Income Credits" of said account shall exceed the "Operating Charges" of the Lessee, the Lessor shall be

entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the "Operating Charges" and "Income Credits" of said account.

The lessee was to account to the lessors for production and operations monthly and payment made on the 20th day of each month "for all royalties due the Lessors during the preceding calendar month." The lessee had the right to surrender the lease at any time and by the surrender and the execution of a quitclaim deed be released from all further drilling obligations as to such surrendered land. Upon the termination of the lessee's rights "the title to all unsevered petroleum, oil, natural gas and other hydrocarbon substances lying in and under the demised premises shall revert to the respective owners thereof * * *." If the lessee failed for a period of 90 days after written notice given by the lessors to comply with any provisions of the lease, the lessors could, at their option, terminate the lease, with exceptions not here material. [87]

During 1938, 1939, and 1940, petitioner received from Standard Oil Company, pursuant to paragraph 31 A of the Standard leases dated April 12, 1924, and January 6, 1925, gross income from primary royalties in aggregate amounts as follows:

Year	Amount
1938	$50,321.41
1939	45,771.09
1940	39,534.63

During the taxable years petitioner received from Standard Oil Company, pursuant to paragraph 31 B of the aforesaid lease, aggregate sums of money, as follows:

Year	Amount
1938	$62,327.91
1939	52,693.39
1940	44,506.39

During the taxable years petitioner received in cash royalties from Associated Oil Company, pursuant to paragraph 22 of the lease dated April 18, 1924, aggregate sums of money as follows:

Year	Amount
1938	$19,700.03
1939	20,275.00
1940	20,958.88

During the taxable years petitioner received from Associated Oil Company, pursuant to paragraph 23 of the lease dated April 18, 1924, aggregate sums of money as follows:

Year	Amount
1938	$34,729.20
1939	34,883.54
1940	39,941.02 [88]

In determining the deficiencies respondent included in gross income for the respective years the amounts received from Standard and Associated Oil Companies, but allowed deductions for percentage depletion only with respect to receipts under paragraph 31 A of the Standard leases and paragraph 22 of the Associated lease.

Respondent contends that petitioner, as the owner and lessor of oil lands, is not entitled to percentage depletion upon amounts received from her lessees which represent a percentage of the net profits of the lessees from their operations on the lease premises. The controversy relates solely to the lessor's right to deplete these additional payments to be made under the prescribed circumstances and conditions set forth in these leases, and no controversy exists between the parties as to the lessor's right to deplete the one-fifth and one-sixth parts of production provided for in paragraph 31 A of the Standard leases and the one-sixth primary royalty as provided for in paragraph 22 of the Associated lease. **For convenience, therefore, we shall refer to the one-fifth and one-sixth interests retained by the lessor as a royalty interest, or royalty, and to the additional payments to be made by the lessees under said stated conditions and circumstances as "net profits."** Respondent submits that the petitioner's right to share in the net profits of her lessees is not such an economic interest in oil in place as will entitle her to a percentage depletion deduction thereon.

We believe that respondent's argument ignores the critical factor in this case. Petitioner retained an economic interest in the oil by virtue of the royalty interest retained in each of the leases. Having [89] such an interest, the question is what was her "gross income from the property" under section 114 (b)(3) for the purpose of the depletion deduction allowed by section 23 (m) of the Internal

Revenue Code. This question was considered and decided in our decision in Kirby Petroleum Co., 2 T. C. . . . , promulgated December 30, 1943, which followed W. S. Green, 26 B. T. A. 1017, and Marrs McLean, 41 B. T. A. 565, and distinguished Helvering v. Elbe Oil Land Development Co., 303 U. S. 372. Upon the authority of the Kirby Petroleum Co. case and the cases therein cited, decision here must be for the petitioner on the contested issue.

In addition we wish to point out that the leases granted the exclusive right to develop and operate the premises for oil, gas and other minerals. The other property rights were retained by lessors. The interest retained by the petitioner-lessor was unquestionably an economic interest, and under the terms of the leases, the lessees were entitled only to that portion of the oil, gas and other mineral produced, extracted and saved, and upon forfeiture or surrender of the leases, or any part thereof, the economic interest would still be in the petitioner-lessor to the extent of her one-third ownership thereof.

Since other adjustments were involved in determining the deficiencies herein, and since respondent erred in the making of certain of said adjustments, as stipulated by the parties.

Enter:

Decision will be entered under Rule 50.

Entered Mar 24 1944 [90]

The Tax Court of the United States
Washington

Docket No. 111047

ANNA VICKERS CRAWFORD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Court's Memorandum Opinion, entered March 24, 1944, the respondent having filed a recomputation of tax on May 16, 1944, and the petitioner having filed an acquiescence in said recomputation on June 2, 1944, it is

Ordered and Decided: That there are deficiencies in income tax of $126.99, $65.29 and $95.13 for the calendar years 1938, 1939, and 1940, respectively.

(Signed) WILLIAM W. ARNOLD
Judge.

Entered Jun 7 1944

(Copies Served on Both Parties) [91]

In the United States Circuit Court of Appeals
for the Ninth Circuit

BTA Docket No. 111047

JOSEPH D. NUNAN, JR.
Commissioner of Internal Revenue,
Petitioner on Review,

v.

ANNA VICKERS CRAWFORD,
Respondent on Review.

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

Now Comes Joseph D. Nunan, Jr., Commissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and Bernard D. Daniels, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I.

JURISDICTION

Joseph D. Nunan, Jr., United States Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding office by virtue of the laws of the United States, hereby petitions the United States Circuit Court of Appeals for the Ninth Circuit to review the decision entered by The

Tax Court of the United States on June 7, 1944, pursuant to its Memorandum [92] Opinion entered March 24, 1944, ordering and deciding that there are deficiencies in income tax in the amounts of $126.99, $65.29 and $95.13 for the calendar years 1938, 1939, and 1940, respectively, due from Anna Vickers Crawford, respondent on review.

That Anna Vickers Crawford, respondent on review, hereinafter referred to as the taxpayer, filed her individual income tax returns for the calendar years 1938, 1939 and 1940 with the Collector of Internal Revenue for the Sixth District of California, at Los Angeles, California, whose office is within the jurisdiction of the United States Circuit Court of Appeals for the Ninth Circuit.

This petition for review is filed pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

II.

NATURE OF CONTROVERSY

At all times herein mentioned taxpayer owned an undivided one-third interest in and to certain property situated in the County of Los Angeles, California, known as Rancho La Ballona, a tract of land of 417.330195 acres. On or about April 12, 1924, taxpayer, together with Florence Vickers McAllister and Clara Vickers Naftzger, each the owner of an undivided one-third interest as her separate property, as lessors executed a lease with Standard Oil Company, a California corporation, for the drilling of oil on a portion of the Rancho La Ballona property.

On or about January 6, 1925 the same parties executed a second lease for the drilling of oil on another portion of the said Rancho La Ballona property. [93]

On or about April 18, 1924, the taxpayer, together with Florence Vickers McAllister and Clara Vickers Naftzger, as lessors, executed a lease with the Associated Oil Company, a California corporation, for the drilling of oil on another portion of the said Rancho La Ballona property.

In each of the three leases the lessors retained a royalty interest. In addition, the leases provided that a certain percentage of the "net profits" derived from the operations on said property be paid to the lessors.

During the years 1938, 1939 and 1940, the taxpayer received "royalties" from the Standard Oil Company in the respective amounts of $50,321.41, $45,771.09 and $39,534.63, and, from Associated Oil Company for said years, "royalties" in the respective amounts of $19,700.03, $20,275.00 and $20,958.88. In addition to the "royalties" received, the taxpayer received a portion of the "net profits" from the operation of the property, from the Standard Oil Company for the years 1938, 1939 and 1940 the respective amounts of $62,327.91, $52,693.39 and $44,506.39, and from the Associated Oil Company for said years the respective amounts of $54,729.20, $34,883.54 and $39,941.02. All of the money so received, was included in the taxpayer's gross income for the respective years.

In computing the net income for each of the years 1938, 1939 and 1940 the taxpayer claimed as a deduction statutory depletion in the amount of 27½ per cent on all of the income received from the Standard Oil Company and the Associated Oil Company pursuant to the terms of the leases. The [94] Commissioner, in his determination of the taxpayer's net income for said years, allowed as a deduction statutory depletion of 27½ per cent with respect to the "royalty" income received by the taxpayer, and, disallowed as a deduction the statutory depletion claimed by the taxpayer with respect to the "net profits" received under the terms of the leases. The amounts of "net profits" received by the taxpayer from the operation of the property in each of the years 1938, 1939 and 1940 were, respectively, $97,057.11, $87,576.93 and $84,447.41, and the amounts of statutory depletion disallowed as a deduction by the Commissioner on said income were respectively, $26,690.71, $24,083.66 and $23,223.04. The decision of The Tax Court holds that the taxpayer-lessor retained an economic interest in the oil by virtue of the royalty interest retained in each of the leases and, therefore, entitled to statutory depletion with respect to the "net profits" from the operation of the property received in the years 1938, 1939 and 1940.

The Commissioner presents that the decision of The Tax Court is erroneous as being contrary to the weight of authority and the controlling principles of economic interest concept in respect to depletable oil and gas properties.

III.

ASSIGNMENTS OF ERROR

That the Commissioner, being aggrieved by the opinion and decision of The Tax Court of the United States in this proceeding, hereby petitions [95] for a review of said opinion and decision by the United States Circuit Court of Appeals for the Ninth Circuit, and for the correction of the manifest errors which therein occurred, and intervened to his prejudice. The errors committed by The Tax Court, which are relied upon by the Commissioner as the basis of this petition for review, are as follows:

That The Tax Court of the United States erred:

(1) In holding and deciding that the taxpayer is entitled to deductions for percentage depletion in the years 1938, 1939 and 1940 in the respective amounts of $26,690.71, $24,083.66 and $23,223.04.

(2) In failing to hold and decide that the taxpayer is not entitled to deductions for percentage depletion for the years 1938, 1939 and 1940 in the respective amounts of $26,690.71, $24,083.66, and $23,223.04.

(3) In holding and deciding, in effect, that the amounts of $97,057.11, $87,576.93 and $84,447.41, received by the taxpayer in the years 1938, 1939 and 1940, respectively, were paid to her by reason of a reserved interest in oil in place.

(4) In failing to hold and decide that the amounts of $97,057.11, $87,576.93 and $84,447.41 received by the taxpayer in the years 1938, 1939 and

1940, respectively, were not paid to her by reason of a reserved interest in oil in place.

(5) In holding and deciding that the amounts of $97,057.11, $87,576.93 and $84,447.41 received by the taxpayer in the years 1938, 1939 and 1940, respectively, represented proceeds from an economic or depletable interest in oil in place. [96]

(6) In ordering and deciding that there are deficiencies in income tax for the years 1938, 1939 and 1940 in the respective amounts of $126.99, $65.29 and $95.13.

(7) In failing to hold and decide that there are deficiencies in income tax for the years 1938, 1939 and 1940 in the respective amounts of $16,675.23, $14,997.16 and $15,933.23.

(8) In that its decision is contrary to law and regulations and is not supported by substantial evidence.

Wherefore, the Commissioner petitions that said findings of fact and opinion and decision of The Tax Court of the United States be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with the law and the rules of said Court and be transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors herein com-

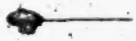
plained of may be reviewed and corrected by said Court.

(Signed) SAMUEL O. CLARK, Jr. CAR
Assistant Attorney General
Signed J. P. WENCHEL CAR
Chief Counsel
Bureau of Internal Revenue
Counsel for Petitioner on Review

Of Counsel:

BERNARD D. DANIELS
Special Attorney
Bureau of Internal Revenue

[Endorsed]: T.C.U.S. Filed Aug. 28, 1944. [97]



[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Sidney D. Krystal, Esquire
505 Title Insurance Building
433 South Spring Street
Los Angeles, California
Attorney for Respondent on Review.

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-eighth day of August, 1944, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, of the

decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review, as filed, is hereto attached and served upon you.

Dated this twenty-eighth day of August, 1944.

Signed J. P. WENCHEL CAR
Chief Counsel
Bureau of Internal Revenue

Personal service of the above and foregoing notice, together with a copy of the petition for review is hereby acknowledged this 2nd day of September, 1944.

(Sgd.) SIDNEY D. KRYSTAL
Attorney for Respondent on Review

[Endorsed]: T.C.U.S. Filed Sept. 21, 1944. [98]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING PETITION FOR REVIEW

To: Mrs. Anna Vickers Crawford
822 Roosevelt Building
727 West Seventh Street
Los Angeles, California

You are hereby notified that the Commissioner of Internal Revenue did, on the twenty-eighth day of August, 1944, file with the Clerk of The Tax Court of the United States, at Washington, D. C., a petition for review by the United States Circuit

Court of Appeals for the Ninth Circuit, of the decision of The Tax Court of the United States heretofore rendered in the above-entitled cause. A copy of the petition for review as filed, is hereto attached and served upon you.

Dated this twenty-eighth day of August, 1944.

(Signed) J. P. WENCHEL, CAR
Chief Counsel, Bureau of Internal Revenue

Personal service of the above and foregoing notice, together with a copy of the petition for review is hereby acknowledged this 2nd day of September, 1944.

(Signed) ANNA VICKERS CRAWFORD
Respondent on Review

[Endorsed]: T.C.U.S. Filed Sept. 21, 1944. [99]

[Title of Circuit Court of Appeals and Cause.]

NOTICE OF FILING DESIGNATION OF CONTENTS OF RECORD ON REVIEW AND STATEMENT OF POINTS

To: Sidney D. Krystal, Esquire
505 Title Insurance Building
433 South Spring Street
Los Angeles, California
Attorney for Respondent on Review

Please take notice that on the 23rd day of September, 1944, the Commissioner of Internal Rev-

enue, petitioner on review, by his counsel, Samuel O. Clark, Jr. Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, filed with the Clerk of The Tax Court of the United States as a Designation of Contents of Record on Review and a Statement of Points, in the above-entitled cause.

Copies of the Designation of Contents of Record on Review and the Statement of Points, as filed, are attached hereto and served upon you.

Dated this 23rd day of September, 1944.

(Signed) SAMUEL O. CLARK, JR., SLY
Assistant Attorney General

(Signed) J. P. WENCHEL, SLY
Chief Counsel, Bureau of Internal Revenue

Service of the foregoing Notice of Filing and one copy each of the Designation of Contents of Record on Review and Statement of Points, are hereby acknowledged this 26th day of September, 1944.

(Signed) SIDNEY D. KRYSTAL
Attorney for Respondent on Review

[Endorsed]: T.C.U.S. Filed Oct. 2, 1944. [100]

[Title of Circuit Court of Appeals and Cause.]

STATEMENT OF POINTS

Now Comes Joseph D. Nunan, Jr., Commissioner of Internal Revenue, the petitioner on review, by his counsel, Samuel O. Clark, Jr., Assistant Attorney General, and J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and hereby asserts the following errors on which he intends to rely in this review:

1. The Tax Court of the United States erred in holding and deciding that the taxpayer is entitled to deductions for percentage depletion in the years 1938, 1939 and 1940 in the respective amounts of $26,690.71, $24,083.66 and $23,223.04.

2. The Tax Court of the United States erred in failing to hold and decide that the taxpayer is not entitled to deductions for percentage depletion for the years 1938, 1939 and 1940 in the respective amounts of $26,690.71, $24,083.66 and $23,223.04.

[101]

3. The Tax Court of the United States erred in holding and deciding in effect, that the amounts of $97,057.11, $87,576.93 and $84,447.41, received by the taxpayer in the years 1938, 1939 and 1940, respectively, were paid to her by reason of a reserved interest in oil in place.

4. The Tax Court of the United States erred in failing to hold and decide that the amounts of $97,057.11, $87,576.93 and $84,447.41 received by the taxpayer in the years 1938, 1939 and 1940, respectively, were not paid to her by reason of a reserved interest in oil in place.

5. The Tax Court of the United States erred in holding and deciding that the amounts of $97,057.11, $87,576.93 and $84,447.41 received by the taxpayer in the years 1938, 1939 and 1940, respectively, represented proceeds from an economic or depletable interest in oil in place.

6. The Tax Court of the United States erred in ordering and deciding that there are deficiencies in income tax for the years 1938, 1939 and 1940 in the respective amounts of $126.99, $65.29 and $95.13.

7. The Tax Court of the United States erred in failing to hold and decide that there are deficiencies in income tax for the years 1938, 1939 and 1940 in the respective amounts of $16,675.23, $14,997.16 and $15,933.23.

8. The Tax Court of the United States erred in that its decision is contrary to law and regulations and is not supported by substantial evidence.

(Signed) SAMUEL O. CLARK, JR., CAR
Assistant Attorney General

(Signed) J. P. WENCHEL, CAR
Chief Counsel, Bureau of Internal Revenue

Service of a copy of the within Statement of Points is hereby admitted this.....day of ....., 1944.

.....
Attorney for Respondent on Review

[Endorsed]: T.C.U.S. Filed Sept. 23, 1944. [102]

[Title of Circuit Court of Appeals and Cause.]

DESIGNATION OF CONTENTS OF RECORD ON REVIEW

To the Clerk of The Tax Court of the United States:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Ninth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petition (including Exhibit "A", deficiency letter attached).
   (b) Answer.
3. Agreed Stipulation of Facts with Exhibits 1-A, 2-B and 3-C attached.
4. Memorandum Opinion of The Tax Court of the United States.
5. Decision of The Tax Court of the United States.
6. Petition for Review, together with proof of service of notice of filing petition for review and of service of a copy of the Petition for Review.

[103]

7. Notice of Filing Designation of Contents of Record on Review and Statement of Points, to-

gether with proof of service of Notice of Filing and service of a copy of each document, as filed.

8. Statement of Points to be relied upon.

9. This Designation of Contents of Record on Review.

(Signed) SAMUEL O. CLARK, JR., CAR
Assistant Attorney General

(Signed) J. P. WENCHEL, CAR
Chief Counsel, Bureau of Internal Revenue
Counsel for Petitioner on Review

Service of a copy of the within Designation of Contents of Record on Review is hereby admitted and agreed to this....day of....., 1944.

.....
Sidney D. Krystal
505 Title Insurance Building
433 South Spring Street
Los Angeles, California
Attorney for Respondent on Review

[Endorsed]: T.C.U.S. Filed Sept. 23, 1944. [104]

The Tax Court of the United States
Washington.

Docket No. 111047

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

ANNA VICKERS CRAWFORD,
Respondent.

CERTIFICATE

I, B. D. Gamble, clerk of The Tax Court of the United States do hereby certify that the foregoing pages, 1 to 104, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of The Tax Court of the United States, at Washington, in the District of Columbia, this 2nd day of Oct., 1944.

[Seal] B. D. GAMBLE,
Clerk, The Tax Court of the
United States

[Endorsed]: No. 10885. United States Circuit Court of Appeals for the Ninth Circuit. Commissioner of Internal Revenue, Petitioner, vs. Anna Vickers Crawford, Respondent. Transcript of the Record. Upon Petition to Review a Decision of The Tax Court of the United States.

Filed October 6, 1944.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 10,885

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

ANNA VICKERS CRAWFORD,
Respondent.

PETITIONER'S DESIGNATION OF RECORD TO BE PRINTED IN THE RECORD ON APPEAL

The Commissioner of Internal Revenue, petitioner, having taken an appeal to the Circuit Court of Appeals for the Ninth Circuit from the judgment of the Tax Court of the United States rendered in this case, designates all of the record on

appeal in Docket No. 10885 (including this "Designation") for printing.

SAMUEL O. CLARK, JR.,
Assistant Attorney General

Dated: October 28, 1944.

Service of the above Designation of Record to be Printed in the Record on Appeal admitted this 28th day of October, 1944.

SIDNEY D. KRYSTAL

[Endorsed]: Filed Oct. 30, 1944. Paul P. O'Brien, Clerk.

Proceedings Had in the United States Circuit Court of Appeals for the Ninth Circuit

Excerpt from Proceedings of Friday, March 16, 1945.
Before DENMAN, STEPHENS, AND HEALY, Circuit Judges.

Order of submission

Ordered petition to review herein argued by Mr. Hilbert P. Zarky, Special Assistant to the Attorney General, counsel for petitioner, and by Mr. Sidney D. Krystal, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings of Saturday, April 21, 1945.
Before DENMAN, STEPHENS, AND HEALY, CJJ.

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this Court in accordance with the opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10,885

COMMISSION OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD, RESPONDENT

Upon Petition to Review a Decision of the Tax Court of the United States

April 21, 1945

Before DENMAN, STEPHENS, and HEALY, Circuit Judges.

DENMAN, Circuit Judge. Petitioner seeks a review of the Tax Court's order holding that the taxpayer, owner of California oil land, who has made two leases of portions thereof to the Standard Oil Company of California, the lessee, to drill for and produce oil therefrom, which leases are terminable by breach of the drilling and other agreements of the lessee, is entitled to depletion deductions for the agreed royalty of a percentage of the net profits of

the lessee from its sale of oil extracted from the leased land. The tax years in question are 1938, 1939, and 1940.

The Tax Court relied, in part, upon our decision in Commissioner v. Felix Oil Co., 144 F. 2d 276, in which we decided that such a lessor is entitled to such deductions for the tax years 1938 and 1939 as a part of the "gross income from property" under Sec. 114 (b) (3) of the Revenue Code. This same section is controlling for the tax year 1940.

Petitioner's brief and argument in the instant case present the same argument, based upon the same authorities, as in the Felix case, save that it cites the recent case of Commissioner v. Kirby Petroleum Co., decided by the Fifth Circuit on March 5, 1945, Judge Hutcheson dissenting.

In that case the majority opinion states of such a payment of net profits as here reserved that it "is not the payment in kind of royalty oil or its equivalent" and contends that the net profit from the operation and sale of the oil paid to the owner of the land is not part of the gross income the land owner receives from the property. Unless the majority opinion can be distinguished on the ground that in Texas the title to the oil passes to the lessee,[1] whereas in California [2] it remains in the lessor, we are not in accord with its holding.

The Supreme Court cases relied upon in the Kirby Petroleum case are all based on the absence of a property interest in the oil property at the time the income from its sale is paid. In Helvering v. O'Donnell, 303 U. S. 370, as here, "The question is whether respondent [taxpayer] had an interest, that is, a capital investment, in the oil and gas in place." It was held that the taxpayer's prior interest was merely that of a stockholder in the corporation owning the oil land and that, as stockholder, he did not have any capital interest in the corporation's property. Hence he was not entitled to depletion on the "one-third of the net profits derived from the development and operation of the properties."

In Helvering v. Elbe Oil Land Development Co., 303 U. S. 372, the taxpayer had conveyed all his interest in the oil land. Relying upon the O'Donnell case, the Supreme Court held that the net profits from the operation agreed to be paid after title had passed from the taxpayer were not subject to depletion.

In these two cases all the Supreme Court's discussion of capital interest in the oil becomes meaningless if a royalty is not subject

[1] Theisen v. Robinson, 117 Texas 489, 516, 8 S. W. 646, 651; Group No. 1 Oil Corp. v. Bass, 283 U. S. 279, 281.

[2] Under California law the owner of oil land, who leases it for oil production with a royalty interest therein, retains his fee therein. The lessee has a profit a prendre in the right to take the oil. If the owner transfers to another his right to collect the royalty, the owner retains the title in the land and the transferee of the royalty has an easement therein. Callaghan v. Martin, 3 Cal. 2d 110, 123, 124.

to depletion if payable in "net profits" of the operation. Cf. dissent Judge Hutcheson in Kirby case.

The Kirby majority opinion does not question that if the royalty there had been a fraction of the gross cash proceeds received by the lessee from the sale of the oil taken from the land, it would be subject to depletion as "gross income from the property" to the taxpayer. Cf. Thomas v. Perkins, 301 U. S. 655; Anderson v. Helvering, 310 U. S. 404, 407, 410. We are unable to see that it is any less "gross income" to the taxpayer from his interest in the fee in the property because the lessee deducts its cost of production before paying the taxpayer. That it is net proceeds to the lessee does not make it any the less the gross income from the land to the owner of the fee. Cf. dissent of Judge Hutcheson.

The majority opinion in the Kirby case seems to regard as a reason the net income from the oil is to be deemed not within the depletion provision, that it requires more calculation than the determination of the sales price of the oil produced from the taxpayer's fee. We can see no reason why the calculations necessary in all other net profit income returned during the taxable year makes the royalty paid the taxpayer any the less part of the gross income to the taxpayer from the fee owned by him. We see nothing in Commissioner v. Kirby or the argument here to require an overruling of our decision in Commissioner v. Felix Oil Co., supra.

The order of the Tax Court is

Affirmed.

(Endorsed.) Opinion filed April 21, 1945.

PAUL P. O'BRIEN, *Clerk.*

Judgment

Upon petition to review a Decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from The Tax Court of the United States, and was duly submitted:

On Consideration Whereof, It is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this cause be, and hereby is affirmed.

(Endorsed) Judgment. Filed and entered April 21, 1945.

PAUL P. O'BRIEN, *Clerk.*

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to Record Certified Under Rule 38 of the Revised Rules of the Supreme Court of the United States

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing

one hundred and thirty-six (136) pages, numbered from and including 1 to and including 136, to be a full, true and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of Hon. Charles Fahy, Solicitor General of the United States, counsel for the petitioner, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 13th day of June 1945.

[SEAL] PAUL P. O'BRIEN, *Clerk:*

U. S. GOVERNMENT PRINTING OFFICE: 1945

Supreme Court of the United States

Order allowing certiorari

Filed October 8, 1945

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary docket and set to follow No. 56.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice JACKSON and Mr. Justice BURTON took no part in the consideration or decision of this application.

U. S. GOVERNMENT PRINTING OFFICE: 1945

FILE COPY

Office - Supreme Court, U. S.
FILED
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CHARLES ELMORE CROPLEY
CLERK

No. 197

In the Supreme Court of the United States

OCTOBER TERM, 1945

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. —

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in this case.

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 103–112) is unreported. The opinion of the circuit court of appeals (R. 131–133) has not yet been reported.

JURISDICTION

The judgment of the circuit court of appeals was entered on April 21, 1945 (R. 133). The jurisdiction of this Court is invoked under Sec-

tion 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of an undivided one-third interest in certain property containing oil and gas deposits. She entered into several leases whereby the lessees became obligated to pay to the taxpayer royalty payments, i. e., a share of the production of oil and gas or its gross proceeds, and also a share of the net profits derived from the oil and gas produced.

The question is whether the circuit court of appeals erred in holding that the taxpayer was entitled, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue Code, to a depletion deduction on the portion of the net profits received by her.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of the statutes and Regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The facts in this case were stipulated by the parties and the Tax Court found the facts as stipulated (R. 26–100, 103).

The taxpayer is an individual residing in Los Angeles, California. Her tax returns for each of the taxable years in question were filed with the Collector of Internal Revenue for the Sixth District of California (R. 26, 103).

The taxpayer owned an undivided one-third interest in certain real property situated in the County of Los Angeles, California (R. 27, 104). On April 12, 1924, taxpayer, together with the owners of the remaining interests in the property, executed a lease with the Standard Oil Company, a California corporation, as lessee, for the drilling of oil on a portion of the property (R. 27, 104). The lessee was granted "the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances" from the property (R. 33). The exclusive drilling and operating rights were granted for two years and for so long thereafter as the lessee should conduct drilling operations and so long as oil and gas were produced in paying quantities (R. 33, 104).

The lessee paid $75,000 at the time of the execution of the lease and agreed to commence the drilling of a well within two years and to continue with reasonable diligence until oil was found in paying quantities (R. 33–34, 104). At any time within two years, the lessee could terminate the lease and surrender the premises; however, if oil were discovered on adjoining property during the first twenty-one months of the lease, the lessee was obligated to commence the drilling of a well within three months or terminate the lease (R. 34, 104–105). If the lessee had not commenced the drilling of a well within one year after execution

of the lease, it was obligated to pay $10 per month per acre or to terminate the lease (R. 35, 105). If the lessee failed to obtain oil in paying quantities from the first well, it was required to commence the drilling of another well within ninety days in order to retain its rights under the agreement (R. 36, 105).

If oil was found in paying quantities, additional wells were to be drilled as rapidly as at least two strings of tools working with due diligence could complete them until a specified number of wells had been drilled (R. 36–37, 105). After completion of the first or any subsequent well, the lessee could cease further drillings, surrender the premises and terminate the agreement, except as to ten acres around each producing or drilling well which could be held free of further drilling obligations so long as oil or gas was produced therefrom (R. 37, 105). The lessee also agreed to commence drilling offset wells within ninety days after discovery of oil within 250 feet of the boundary lines of the property (R. 37–38, 105).

All labor and materials were to be furnished by the lessee (R. 41, 105). The lessee agreed to pay "any and all taxes assessed upon the mineral rights in said premises," as well as the taxes levied against the oil and minerals stored on the premises and against the property and equipment owned by it and located on the property (R. 39).

Paragraph 31 of the lease provided that the lessee should pay to the lessors (R. 45):

> A. As a minimum:
>
> (1) A sum representing the "sale value" as herein defined of the one-fifth (1/5th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.
>
> (2) One-fifth (1/5th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.
>
> (B) Such sum, if any, in addition, as shall represent the amount by which one-half (1/2) of the "net profits" derived from the operations on said property up to the end of such calendar month shall exceed the aggregate of—
>
> (1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus
>
> (2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

The terms "sale value" and "net profits" were defined by the agreement (R. 42–44). If the lessee failed for ninety days after written notice to comply with any provisions of the lease, the lessors had the right to terminate the agreement, except that default as to any well or wells would not

affect the lessee's operation of any other well or wells situated in any other ten acre parcel (R. 46, 107).

On January 6, 1925, the lessors entered into another agreement with the same lessee for the drilling of oil on a different portion of the property. The lease was for a term of five years and so long thereafter as oil and gas were produced in paying quantities unless otherwise surrendered or forfeited by the lessee (R. 52, 107). The provisions of the agreement were substantially the same as those of the first lease between the same parties (R. 49–64, 107). The consideration was different in that $80,000 was paid by the lessee with the execution of the lease (R. 52–53, 107) and the minimum monthly sum to be paid was one-sixth of the "sale value" of the oil, asphaltum and other hydrocarbon substances extracted and one-sixth of the actual proceeds of the gas produced, saved and sold off the premises (R. 63, 107). The provisions for the payment of one-half of the "net profits" were the same as the provisions of paragraph 31B of the prior agreement (R. 63, 107).

On April 18, 1924, the lessors executed another lease with the Associated Oil Company, a California corporation, for drilling of oil on another portion of the same property. The property covered 101 acres, more or less, and was leased for a term of twenty years. (R. 66–96, 107–108.)

The lessee agreed to pay $500 per acre for the privilege of drilling and an oil bonus of $500 per acre to be paid monthly at the rate of one-sixth of the net production until paid (R. 70–71, 108). The lessors were also entitled to a "primary royalty" of one-sixth of the net amount of all petroleum, oil, naphtha and other hydrocarbon substances produced and saved from the property after deducting from the gross product the quantity consumed in the development and operation of the property, and of one-sixth of the proceeds derived from the sale of all gas produced from the property (R. 80, 108). The lessee could contract for the manufacture of casinghead gasoline from gas produced on the premises, provided that at least 35 percent was to be reserved and to be divided, one-sixth to the lessors and five-sixths to the lessee (R. 80–81, 108).

The lessors were entitled, in addition, to receive a "secondary royalty," the agreement providing (R. 84):

> When, and as soon as the "Income Credits" of said account shall exceed the "Operating Charges" of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the "Operating Charges ["] and "Income Credits" of said account.

Paragraph 23 of the agreement defined the terms "Income Credits" and "Operating

Charges" (R. 81–84) in such a manner that the difference between the two sums was comparable to the term "net profits" as used in the leases between the lessors and the Standard Oil Company.

The lease contained provisions for surrender by the lessee, or for termination by the lessors in the event that the lessee failed to comply with the provisions of the agreement (R. 91–93, 109). The lease specifically provided that upon termination of the lessee's rights "the title to all unsevered petroleum, oil, natural gas, and other hydrocarbon substances lying in and under the demised premises shall revert to the respective owners thereof * * *" (R. 91).

During the taxable years in question all three leases were in effect. During the years 1938, 1939, and 1940, taxpayer received, pursuant to paragraphs 31A of the Standard Oil leases, gross income from primary royalties in the aggregate respective amounts of $50,321.41, $45,771.09, and $39,534.63; during the same years taxpayer received pursuant to paragraphs 31B of these leases (one-half of the net profits) the following respective amounts: $62,327.91, $52,693.39, and $44,506.39 (R. 28–29, 109–110).

During the same years taxpayer received primary royalties from Associated Oil Company, pursuant to paragraph 22 of that lease, in the respective amounts of $19,700.03, $20,275, and

$20,958.88; during the same years she received secondary royalties (based on net profits) pursuant to paragraph 23 of the lease, in the respective amounts of $34,729.20, $34,883.54 and $39,941.02 (R. 29, 110).

In calculating her taxable income for the years in question, taxpayer deducted statutory depletion at the rate of 27½ percent of the respective amounts set forth above. The Commissioner determined deficiencies for income taxes for the years 1938, 1939 and 1940, resulting in part from his determination that taxpayer was not entitled to deduct depletion on the amounts received by her as a division of net profits and paid pursuant to paragraph 31B of the Standard Oil leases and paragraph 23 of the Associated Oil Company lease (R. 29–30, 103).

The taxpayer sought a redetermination of the deficiencies before the Tax Court. The Tax Court refused to uphold the Commissioner's determination in this respect, ruling that the taxpayer was entitled to a deduction for statutory depletion on all amounts received by her pursuant to the above mentioned leases (R. 103–112). The circuit court of appeals affirmed the decision of the Tax Court.

SPECIFICATION OF ERRORS TO BE URGED

The circuit court of appeals erred in holding that, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue

Code, the taxpayer was entitled to percentage depletion on the share of the lessees' net profits paid to her, and in affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The decision in this case is directly in conflict with that of the Circuit Court of Appeals for the Fifth Circuit in *Commissioner* v. *Kirby Petroleum Co.*, 148 F. 2d 80, certiorari granted, May 21, 1945, No. 1139, this Term. The court below stated in the instant case that it was not in accord with the holding in the *Kirby* case unless it could be distinguished on the ground that Texas law with respect to title to the underlying oil was different from that of California. Since this Court has held that local rules of law respecting title to the oil in place are irrelevant in determining questions of taxability and depletion (*Burnet* v. *Harmel*, 287 U. S. 103), it is believed that the cases cannot be distinguished on that ground.

2. The decision below is erroneous in that it ignores the principle, enunciated by this Court, that a person who has the right to receive a share of the net profits derived from the production and sale of oil and gas does not have a proportionate depletable interest in the underlying oil and gas. *Helvering* v. *O'Donnell*, 303 U. S. 370; *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372; *Anderson* v. *Helvering*, 310 U. S. 404.

3. The Commissioner of Internal Revenue advises that a question of large importance in the administration of the revenue laws is presented.

CONCLUSION

For the foregoing reasons, and because certiorari was granted to review *Commissioner* v. *Kirby Petroleum Co., supra,* this petition for a writ of certiorari should be granted.

Respectfully submitted.

HUGH B. COX,
Acting Solicitor General.

JUNE 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income

allocable to each. (26 U. S. C., Sec. 23.)

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis For Depletion.*—

* * * * *

(3) *Percentage Depletion For Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the propetry, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C., Sec. 114.)

The provisions of Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are identical.

Treasury regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1 [as amended by T. D. 5413, 1944-22 Int. Rev. Bull. 4]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits,

and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

(f) * * *

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

The provisions of Artiele 23 (m)-1 of Treasury Regulations 101 promulgated under Revenue Act of 1938 are substantially the same.

U. S. GOVERNMENT PRINTING OFFICE: 1943

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No. 197

In the Supreme Court of the United States

OCTOBER TERM, 1945

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 197

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA VICKERS CRAWFORD

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 103–112) is unreported. The opinion of the Circuit Court of Appeals (R. 131–133) is reported at 148 F. 2d 776.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 21, 1945 (R. 133). The petition for a writ of certiorari was filed on July 3, 1945, and was granted on October 8, 1945, the case being set to follow *Kirby Petroleum Co.* v. *Commissioner,* No. 56, this Term (R. 134). The

jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer was the owner of an undivided one-third interest in certain property containing oil and gas deposits. She entered into several leases whereby the lessees became obligated to pay to the taxpayer royalty payments, *i. e.*, a share of the production of oil and gas or its gross proceeds, and also a share of the net profits derived from the oil and gas produced.

The question is whether the Circuit Court of Appeals erred in holding that the taxpayer was entitled, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue Code, to a depletion deduction on the portion of the net profits received by her.

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 12–16.

STATEMENT

The facts in this case were stipulated by the parties and the Tax Court found the facts as stipulated (R. 26–100, 103).

The taxpayer is an individual residing in Los Angeles, California. Her tax returns for each of the taxable years in question were filed with

the Collector of Internal Revenue for the Sixth District of California (R. 26, 103).

The taxpayer owned an undivided one-third interest in certain real property situated in the County of Los Angeles, California (R. 27, 104). On April 12, 1924, taxpayer, together with the owners of the remaining interests in the property, executed a lease with the Standard Oil Company, a California corporation, as lessee, for the drilling of oil on a portion of the property (R. 27, 104). The lessee was granted "the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances" from the property (R. 33). These exclusive drilling and operating rights were granted for two years and for so long thereafter as the lessee should conduct drilling operations and so long as oil and gas were produced in paying quantities (R. 33, 104).

The lessee paid $75,000 at the time of the execution of the lease and agreed to commence the drilling of a well within two years and to continue with reasonable diligence until oil was found in paying quantities (R. 33–34, 104). At any time within two years, the lessee could terminate the lease and surrender the premises; however, if oil were discovered on adjoining property during the first twenty-one months of the lease, the lessee was obligated to commence the drilling of a well within three months or terminate the lease (R. 34, 104–105). If the

lessee had not commenced the drilling of a well within one year after execution of the lease, it was obligated to pay $10 per month per acre or to terminate the lease (R. 35, 105). If the lessee failed to obtain oil in paying quantities from the first well, it was required to commence the drilling of another well within ninety days in order to retain its rights under the agreement (R. 36, 105).

If oil was found in paying quantities, additional wells were to be drilled as rapidly as at least two strings of tools working with due diligence could complete them until a specified number of wells had been drilled (R. 36–37, 105). After completion of the first or any subsequent well, the lessee could cease further drillings, surrender the premises and terminate the agreement, except as to ten acres around each producing or drilling well which could be held free of further drilling obligations so long as oil or gas was produced therefrom (R. 37, 105). The lessee also agreed to commence drilling offset wells within ninety days after discovery of oil within 250 feet of the boundary lines of the property (R. 37–38, 105).

All labor and materials were to be furnished by the lessee (R. 41, 105). The lessee agreed to pay "any and all taxes assessed upon the mineral rights in said premises," as well as the taxes levied against the oil and minerals stored on the premises and against the property and equipment owned by it and located on the property (R. 39).

Paragraph 31 of the lease provided that the lessee should pay to the lessors (R. 45):

> A. As a minimum:
>
> (1) A sum representing the "sale value" as herein defined of the one-fifth (⅕th) part of all oil, asphaltum and other hydrocarbon substances, other than gas, extracted and saved from the said premises during the preceding calendar month.
>
> (2) One-fifth (⅕th) of the actual proceeds of all gas produced and saved and sold off the premises by second party during such preceding calendar month.
>
> (B) Such sum, if any, in addition, as shall represent the amount by which one-half (½) of the "net profits" derived from the operations on said property up to the end of such calendar month shall exceed the aggregate of—
>
> (1) All sums theretofore paid to first parties by second party pursuant to the provisions of this paragraph (31), plus
>
> (2) The amount contemporaneously payable by second party to first parties pursuant to the provisions of Subdivision A of this paragraph.

The terms "sale value" and "net profits" were defined by the agreement (R. 42–44). If the lessee failed for ninety days after written notice to comply with any provisions of the lease, the lessors had the right to terminate the agreement, except that default as to any well or wells would not affect the lessee's operation of any other well

or wells situated in any other ten acre parcel (R. 46, 107).

On January 6, 1925, the lessors entered into another agreement with the same lessee for the drilling of oil on a different portion of the property. The lease was for a term of five years and so long thereafter as oil and gas were produced in paying quantities unless otherwise surrendered or forfeited by the lessee (R. 52, 107). The provisions of the agreement were substantially the same as those of the first lease between the same parties (R. 49–64, 107). The consideration was different in that $80,000 was paid by the lessee concurrently with the execution of the lease (R. 52–53, 107) and the minimum monthly sum to be paid was one-sixth of the "sale value" of the oil, asphaltum and other hydrocarbon substances extracted and one-sixth of the actual proceeds of the gas produced, saved and sold off the premises (R. 63, 107). The provisions for the payment of one-half of the "net profits" were the same as the provisions of paragraph 31B of the prior agreement (R. 63, 107).

On April 18, 1924, the lessors executed another lease with the Associated Oil Company, a California corporation, for drilling of oil on another portion of the same property. The property covered 101 acres, more or less, and was leased for a term of twenty years (R. 66–96, 107–108).

The lessee agreed to pay $500 per acre for the privilege of drilling and an oil bonus of $500 per

acre to be paid monthly at the rate of one-sixth of the net production until paid (R. 70–71, 108). The lessors were also entitled to a "primary royalty" of one-sixth of the net amount of all petroleum, oil, naphtha and other hydrocarbon substances produced and saved from the property after deducting from the gross product the quantity consumed in the development and operation of the property, and of one-sixth of the proceeds derived from the sale of all gas produced from the property (R. 80, 108). The lessee could contract for the manufacture of casinghead gasoline from gas produced on the premises, provided that at least 35 percent was to be reserved and to be divided, one-sixth to the lessors and five-sixths to the lessee (R. 80–81, 108).

The lessors were entitled, in addition, to receive a "secondary royalty," the agreement providing (R. 84):

> When, and as soon as the "Income Credits" of said account shall exceed the "Operating Charges" of the Lessee, the Lessor shall be entitled to a secondary and additional royalty, the amount thereof to be one-half of such difference between the "Operating Charges ["] and "Income Credits" of said account.

Paragraph 23 of the agreement defined the terms "Income Credits" and "Operating Charges" (R. 81–84) in such a manner that the difference between the two sums was comparable

to the term "net profits" as used in the leases between the lessors and the Standard Oil Company.

The lease contained provisions for surrender by the lessee, or for termination by the lessors in the event that the lessee failed to comply with the provisions of the agreement (R. 91–93, 109). The lease specifically provided that upon termination of the lessee's rights "the title to all unsevered petroleum, oil, natural gas, and other hydrocarbon substances lying in and under the demised premises shall revert to the respective owners thereof * * *" (R. 91).

During the taxable years in question all three leases were in effect. During the years 1938, 1939, and 1940, taxpayer received, pursuant to paragraphs 31A of the Standard Oil leases, gross income from primary royalties in the aggregate respective amounts of $50,321.41, $45,771.09, and $39,534.63; during the same years taxpayer received, pursuant to paragraphs 31B of these leases (one-half of the net profits), the following respective amounts: $62,327.91, $52,693.39, and $44,506.39 (R. 28–29, 109–110).

During the same years taxpayer received primary royalties from Associated Oil Company, pursuant to paragraph 22 of that lease, in the respective amounts of $19,700.03, $20,275, and $20,958.88; during the same years she received secondary royalties (based on net profits), pur-

suant to paragraph 23 of the lease, in the respective amounts of $34,729.20, $34,883.54, and $39,941.02 (R. 29, 110).

In calculating her taxable income for the years in question, taxpayer deducted statutory depletion at the rate of 27½ percent of the respective amounts set forth above. The Commissioner determined deficiencies for income taxes for the years 1938, 1939 and 1940, resulting in part from his conclusion that taxpayer was not entitled to deduct depletion on the amounts received by her as a division of net profits and paid pursuant to paragraph 31B of the Standard Oil leases and paragraph 23 of the Associated Oil Company lease (R. 29–30, 103).

The taxpayer sought a redetermination of the deficiencies before the Tax Court. The Tax Court refused to uphold the Commissioner's determination in this respect, ruling that the taxpayer was entitled to a deduction for statutory depletion on all amounts received by her pursuant to the above-mentioned leases (R. 103–112). The Circuit Court of Appeals affirmed the decision of the Tax Court (R. 131–133).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in holding that, under Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938 and of the Internal Revenue Code, the taxpayer was entitled to percentage depletion on the share of the lessees' net

profits paid to her, and in affirming the decision of the Tax Court.

SUMMARY OF ARGUMENT

The single deduction for depletion is apportionable between a lessor and a lessee only as each is entitled to share in the production of oil and gas, or the gross proceeds thereof. In this case the lessors retained the right to share in the production of oil and gas only to the extent that cash bonuses were received and to the extent that they were entitled to receive oil and gas royalties. The gross income from this portion of production represented the measure of the depletion deduction to be taken by the lessors. The additional right of the lessors to a part of the net profits earned by the lessees did not evidence a right to share in production, and the net profits received did not represent gross income from the property on which depletion is allowable. Except for the bonuses and royalties paid, all the remaining production was acquired by the lessees and they were entitled to the deduction for depletion on the gross income from that portion of the oil and gas.

The decision of the Tax Court permitting the taxpayer the deduction for depletion on the share of the net profits which she received from the lessees was not in accordance with law and the Circuit Court of Appeals erred in failing to reverse the Tax Court.

ARGUMENT

The reasons set forth in the Commissioner's brief in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, for denying to the lessor in that case the deduction for depletion on the share of the lessees' net profits received, apply with equal force to this case and need not be reiterated. Accordingly, the Court is respectfully referred to the Commissioner's argument in that case for the reasons supporting his position that the court below erred in failing to reverse the decision of the Tax Court in the present case.

CONCLUSION

The judgment of the Circuit Court of Appeals is erroneous and should be reversed.

Respectfully submitted.

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OCTOBER 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument

creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U. S. C. 23)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage Depletion For Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

(26 U. S. C. 114)

The provisions of Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1938, c. 289, 52 Stat. 447, are identical.

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there

shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.

* * * * *

(f) * * *

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments have been paid in respect of the property in the taxable year or any prior years or if advanced royalties have been paid in respect of the property in any taxable year ending prior to December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the product sold during the taxable year. If advanced royalties have been paid in respect of the property in any taxable year ending on or after December 31, 1939, the amount excluded from "gross income from the property" for the current taxable year on account of such payments shall be an amount equal to the deduction for such taxable year taken on account of such payments pursuant to section 19.23 (m)-10 (e).

* * * * *

SEC. 19.23 (m)-4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114 (b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property"

and "net income of the taxpayer (computed without allowance for depletion) from the property," see paragraphs (f) and (g) of section 19.23 (m)-1.) In no case shall the deduction computed under this section be less than it would be if computed upon the cost or other basis of the property provided in section 113.

The provisions of Articles 23 (m)-1 and 23 (m)-4 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, are substantially the same.

U. S. GOVERNMENT PRINTING OFFICE: 1948

IN THE

Supreme Court of the United States

No. 197.

Petitioner

vs.

Respondent

IN PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 197.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ANNA VICKERS CRAWFORD,

Respondent.

BRIEF FOR RESPONDENT.

I.

The Opinions of the Courts Below.

The memorandum opinion of the Tax Court [R. 103-112] is unreported. The opinion of the Circuit Court of Appeals [R. 131-134] is reported in 148 Fed. (2d) 776.

II.

Jurisdiction.

Jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Section 347.

The judgment of the Circuit Court of Appeals was entered April 21, 1945. [R. 133.]

III.

Statement of the Case.

The facts in this case were stipulated by the parties and the Tax Court found the facts as stipulated. [R. 26-100, 103.]

The taxpayer owned an undivided one-third interest in the fee title to certain real property situate in the County of Los Angeles, California. [R. 27, 104.] On April 12, 1924 taxpayer, together with the owners of the remaining interests in the property, executed a lease with the Standard Oil Company, a California corporation, as lessee, for the drilling of oil on a portion of the property. [R. 27, 104.] The lessee was granted "the sole and exclusive right to drill for, produce, extract and take oil, gas, asphaltum and other hydrocarbon substances" from the property. [R. 33.]. The exclusive drilling and operating rights were granted for two years and for so long thereafter as the lessee should conduct drilling operations and so long as oil and gas were produced in paying quantities. [R. 33, 104.]

The lessee paid a bonus of $75,000.00 at the time of the execution of the lease [R. 33-34, 104], and agreed in paragraph 31 A of the lease to pay a minimum royalty of one-fifth of the sale value of all oil, asphaltum and other hydrocarbon substances extracted and saved from the premises and one-fifth of the actual proceeds of all gas produced and saved and sold off the premises. [R. 45.] In addition, pursuant to paragraph 31 B of the lease, the lessee agreed to pay such sum as shall represent the amount

by which one-half of the "net profits" derived from operations on said property shall exceed the aggregate of all royalties theretofore paid plus the bonus paid by the lessee. [R. 45.] The term "net profits" is defined by the lease to mean the amount by which the "gross proceeds" as therein defined exceeded the "chargeable expenses" as therein defined. [R. 43-44.] If the lessee failed for ninety days after written notice to comply with any provisions of the lease, the lessors had the right to terminate the lease, except that default as to any well or wells would not affect the lessee's operation of any other well or wells situated in any other ten acre parcel. [R. 46, 107.]

On January 6, 1925 the lessors entered into another lease with the same lessee for the drilling of oil on a different portion of the property. The lease was for a term of five years and so long thereafter as oil and gas were produced in paying quantities unless the land had otherwise been surrendered or forfeited by the lessee. [R. 52; 107.] The provisions of this lease were substantially the same as those of the first lease between the same parties [R. 49-64; 107] except that the bonus was $80,000 [R. 52-53; 107] and the minimum monthly sum to be paid was one-sixth of the "sale value" of the oil, asphaltum and other hydrocarbon substances extracted and one-sixth of the actual proceeds of the gas produced, saved and sold off the premises. [R. 63, 107.] The provisions for the payment of one-half of certain "net profits" were the same as the provisions of paragraph 31B of the prior lease. [R 63, 107.]

On April 18, 1924, the lessors executed another lease with the Associated Oil Company, a California corporation, for the drilling of oil on another portion of the same property. The property covered 101 acres, more or less, and was leased for a term of twenty years. [R. 66-69; 107-108.]

The lease provided for a "primary royalty" of one-sixth of the oil and gas produced [R. 80, 108], and for a "secondary royalty" in an amount equal to one-half of the difference between certain specified "Operating Charges" and certain specified "Income Credits". [R. 83-84.]

The lease contained provisions for surrender by the lessee, or for termination by the lessors in the event that the lessee failed to comply with the provisions of the agreement. [R. 91-93; 109.]

During the taxable years in question all three leases were in effect. During the years 1938, 1939, and 1940, taxpayer received, pursuant to paragraph 31A of the Standard Oil leases, gross income from primary royalties in the aggregate respective amounts of: $50,321.41, $45,771.09, and $39,534.63; during the same years taxpayer received pursuant to paragraph 31B of these leases the following respective amounts: $62,327.91, $52,693.39, and $44,506.39. [R. 28-29; 109-110.]

During the same years taxpayer received primary royalties from Associated Oil Company, pursuant to paragraph 22 of that lease, in the respective amounts of $19,700.03, $20,275, and $20,958.88; during the same years she received secondary royalties pursuant to paragraph 23 of

the lease, in the respective amounts of $34,729.20, $34,883.54 and $39,941.02. [R. 29; 110.]

In computing her taxable income for the years in question, taxpayer deducted statutory depletion at the rate of 27½ per cent of the respective amounts set forth above. The Commissioner determined deficiencies for income taxes for the years in question resulting in primary part from his determination that taxpayer was not entitled to deduct depletion on the additional or secondary royalties paid pursuant to paragraphs 31B of the Standard Oil leases and paragraph 23 of the Associated Oil Company lease. [R. 29-30; 103.]

The taxpayer sought a redetermination of the deficiencies before the Tax Court. The Tax Court refused to uphold the Commissioner's determinations in this respect, ruling that the taxpayer was entitled to a deduction for statutory depletion on all amounts received by her pursuant to the above mentioned leases. [R. 103-112.] The Circuit Court of Appeals for the Ninth Circuit affirmed the Tax Court's decision. [R. 131-134.]

IV.

Statutes Involved.

Internal Revenue Code:

Sec. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable

allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *
(26 U. S. C. 1940 ed., Sec. 23.)

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(b) *Basis for Depletion.*—

* * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under Section 23(a) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under Section 23(m) be less than it would be if computed without reference to this paragraph.

* * *

(26 U. S. C. 1940 ed., Sec. 114.)

V.

ARGUMENT.

Summary of the Argument.

I. By the execution of the oil and gas leases involved, the taxpayer, as fee owner with full reversionary rights, necessarily retained an economic interest in the oil in place. Consequently all payments received by her from the lessees, including cash bonuses, basic royalties and additional or supplementary royalties measured by a portion of certain net profits derived by the lessees from the production and sale of oil, constitute "gross income from the property" subject to statutory depletion. The leases cannot be deemed to have effected a sale by the taxpayer of any portion of her economic interest in the oil in place.

II. On the basis of the rule of the *Dobson* case, the decision of the Tax Court should be affirmed.

III. In the alternative, if the net profit participation in the results of the lessees' production and sale of oil and gas are not royalties subject to depletion, they must be treated as capital gain.

I.

The Taxpayer as Fee Owner Is Entitled to Statutory Depletion on All Proceeds Received From Her Lessees.

Section 23(m) of the Revenue Act of 1938, and of the Internal Revenue Code provides for a deduction from gross income of a reasonable allowance for depletion in the case of oil and gas wells. Section 114(b)(3) of the Revenue Act of 1938, and of the Internal Revenue Code states that this allowance for depletion shall be 27½ percent "of the gross income from the property during the taxable year." The sole issue in the instant case is what was the taxpayer's gross income from the property during the years 1938, 1939 and 1940.

The taxpayer, respondent herein, contends that as fee owner of land containing oil deposits every dollar received from her lessees constitutes gross income from the property subject to statutory depletion regardless of the method of determining the amount of dollars payable. The fee owner of land subject to an oil and gas lease necessarily has an economic interest in the oil in place because of ownership of the land. Every barrel of oil taken from the land depletes the fee owner's interest in the oil in place and every dollar paid to the fee owner by the lessee in consideration of the extraction and marketing of the oil constitutes recompense to the fee owner for the depletion of the oil in place. Accordingly, all moneys paid to the taxpayer by her lessees constitute "gross income from the property" subject to depletion.

The Commissioner of Internal Revenue has conceded that taxpayer is entitled to depletion on the cash bonuses and basic royalties provided for in the leases involved, but

has denied depletion on the additional or supplementary royalties provided for in the same leases. This position of the Commissioner cannot be supported by the decisions of this Court. It is artificial, illogical and indefensible both as matters of law and economics.

A. THE OWNERSHIP OF AN ECONOMIC INTEREST IN THE OIL IN PLACE DETERMINES THE RIGHT TO DEPLETION.

The ownership of an economic interest in the oil in place is the touchstone to the right to depletion. *Palmer v. Bender*, 287 U. S. 551; *Thomas v. Perkins*, 301 U. S. 655; *Anderson v. Helvering*, 310 U. S. 404.[1] This economic ownership of the oil in place represents the taxpayer's capital interest or investment in a wasting asset, and to the extent oil is extracted, the taxpayer's capital has suffered depletion. Payments of money to the owner of an economic interest in the oil in place on account of the oil extracted are subject to allowances for statutory depletion. *Helvering v. Mountain Producers Corp.*, 303 U. S. 376; *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312.

As to these basic principles, there appears to be no dispute. However, the Commissioner takes the position that in order to determine whether the taxpayer possesses an economic interest in the oil in place, it is necessary to look solely to the method of payment by the lessee or working interest. He then seeks to establish the rule that to the extent there is a participation in the net profits of the work-

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[1]See 4 Mertens, Law of Federal Income Taxation (1942 Ed.) Sec. 34.21; *Depletion Allowances in Taxation of Income Derived from Oil Royalties and Oil Payments*, 47 Yale Law Journal 806 (1938).

ing interest, there can be no economic interest in the oil in place.[2]

The taxpayer believes that in order to determine whether there is ownership of an economic interest in the oil in place, the method of payment by the working interest may be an important factor in certain instances, but it is not the sole determinative factor. Consideration must also be given to the ownership of the real property containing the oil deposit and to the substantive nature of the legal document creating the rights between the parties. The many decisions of this Court in connection with the depletion of oil royalties hold that in the case of an oil and gas lease, the fee owner-lessor always retains an economic interest in the oil in place,[3] whereas in the case of an agreement made by the fee owner which constitutes a sale, an economic interest may or may not have been retained dependent upon the nature of the method of payment by the working interest,[4] and the source of the payments.[5]

B. Net Profit Participation in Results of Drilling May Constitute a Royalty Subject to Depletion.

The Commissioner has contended that participation in the net profits of the working interest can never constitute a royalty subject to depletion. To support this position, the Commissioner relies upon various statements

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[2] See General Counsel Memorandum 22730, 1941-1 C. B. 214.

[3] See *e. g. Burnet v. Harmel*, 287 U. S. 103; *Murphy Oil Co. v. Burnet*, 287 U. S. 299; *United States v. Dakota-Montana Oil Co.*, 288 U. S. 459; *Herring v. Commissioner*, 293 U. S. 322.

[4] *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372.

[5] *Anderson v. Helvering, supra.*

made by this court in its decisions in *Helvering v. Bankline Oil Co.*, 303 U. S. 362; *Helvering v. O'Donnell*, 303 U. S. 370; *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Anderson v. Helvering, supra*. Divorcing these statements from their context and the facts of the particular cases involved, the Commissioner has formulated a principle that is logically and economically indefensible.

In the first place, these four cases do not support the Commissioner's position either as a matter of fact or law. The *Bankline* case did not involve the element of a net profit participation, but the question whether or not the contractual right to extract wet gas at the mouth of a well represented an economic interest in the oil in place. This Court held that it did not, stating "a mere economic advantage derived from production, through a contractual relation to the owner" does not represent an economic interest.

The *O'Donnell* and *Elbe Oil Land Development Co.* cases did involve the element of net profits. There is nothing in these cases, however, which requires or even supports the Commissioner's contentions.

In the *O'Donnell* case the facts were as follows:

The taxpayer owned one-third of the capital stock of the San Gabriel Petroleum Company. He sold this stock to the Petroleum Midway Company, Limited, and as consideration the Midway Company agreed to pay him one-third of the net profits from the development and operation of the oil and gas properties acquired by the Midway Company. The Midway Company acquired the properties of the San Gabriel Petroleum Company, operated them, and one-third of the net profits were paid to the

taxpayer who took depletion against such payments for the years 1925 and 1926.

This Court held that the taxpayer was not entitled to depletion, stating:

> "The question is whether respondent had an interest, that is, a capital investment, in the oil and gas in place. (Citations omitted.) As a mere owner of shares in the San Gabriel Company, respondent had no such interest. Treasury Regulations No. 69, art. 201. The ownership of the oil and gas properties was in the corporation. When the Midway Company acquired these properties from the San Gabriel Company and operated them, the Midway Company became the owner of the oil and gas produced. It was the owner of the gross proceeds or income upon which the statutory allowance for depletion was to be computed. *Helvering v. Twin Bell Syndicate, supra.* The agreement to pay respondent one-third of the net profits derived from the development and operation of the properties was a personal covenant and did not purport to grant respondent an interest in the properties themselves. If there was no net profits, nothing would be payable to him. No trust was declared by which respondent could claim an equitable interest in the *res.* As consideration for the sale of his stock in the San Gabriel Company, respondent bargained for and obtained an economic advantage from the Midway Company's operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place. *Palmer v. Bender, supra; Helvering v. Bankline Oil Company, supra.*"

The basis of this decision is self-evident. The taxpayer did not own an economic interest in the oil in place by virtue of his stock ownership in the corporation holding the oil properties; the sale of his stock could not operate

to convert his stock interest into an economic interest in the oil in place merely because the purchaser agreed to pay a percentage of the net profits derived from the operation of the well. The result in this case would have been the same had O'Donnell received a gross interest in the oil produced.[6]

In the *Elbe Oil Land Development Co.* case, the taxpayer was the owner of certain oil and gas prospecting permits, drilling agreements, leases and equipment. Development work resulted in the discovery of oil and the taxpayer thereafter conveyed all its right, title and interest in and to the said properties to the Honolulu Consolidated Oil Company. The Oil Company agreed to pay the taxpayer $350,000.00 upon the execution of the agreement, and if it should not elect to abandon the purchase, an additional $1,650,000.00 during the years 1928 to 1931. After the company had been fully reimbursed as provided in the agreement for all its expenditures in the acquisition, development and operation of the properties, taxpayer was to receive monthly one-third of the net profits resulting from the production and operation.

The agreement specifically provided that it was the intention of the parties that "the full ownership, possession and control of all of the properties, the subject of this agreement, and of all of the personal property acquired, and/or used on and in connection with the operation and development of the properties, the subject of this agreement, shall be vested in Honolulu, and Elbe shall have no interest in or to said properties * * *."

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[6] *Haynes v. U. S.*, 50 F. Supp. 238 (Ct. Claims, 1943).

The taxpayer treated the down payment of $350,000.00 as capital gain, and during 1928 and 1929, claimed depletion on the payments of $400,000.00 each year received by it.

This Court held that the taxpayer was not entitled to depletion, saying in material part:

> "We agree with the conclusion of the Board of Tax Appeals that the contract between the respondent and the Honolulu Company *provided for an absolute sale of all the properties in question,* including all the oil and gas in place, and that respondent did not retain any interest or investment therein. The aggregate sum of $2,000,000.00 was paid as an agreed purchase price to which was to be added the one-third of the net profits payable on the conditions specified. We are unable to conclude that the provision for this additional payment qualified in any way the effect of the transaction *as an absolute sale or was other than a personal covenant of the Honolulu Company.* See *Helvering v. O'Donnell,* 303 U. S. 370, 58 S. Ct. 619, decided this day." (Emphasis added.)

It appears clear that neither of these two cases supports the rule which the Commissioner is attempting to establish. In the *O'Donnell* case, the taxpayer never had an economic interest in the oil in place. In the *Elbe* case, the taxpayer had an economic interest in the oil in place, but through an absolute and unqualified sale divested itself of such interest. The taxpayer in the *Elbe* case had sold his interest beyond recall or reversion, had received part of the purchase price and been taxed on it as capital gain and then claimed depletion on the balance. All it had left was a right to share in net profits payable if the purchaser first recovered all his costs including the purchase price of the properties. Such right was held not to be an economic interest in the oil in place.

In *Anderson v. Helvering, supra*, the facts were that the Oklahoma City Oil Company owned certain royalty interests, fee interests, and deferred oil payments in properties in Oklahoma. In 1931 the Company entered into a written contract with the taxpayer providing for the conveyance to him of these interests for the agreed consideration of $160,000.00 payable $50,000.00 in cash and $110,000.00 from one-half of the proceeds received by him from oil and gas produced from the properties and from the sale of fee title to any or all of the land conveyed. Interest at the rate of 6 percent per annum was to be paid from the proceeds of production and of sales upon the unpaid balance of the purchase price. The Company was to have a first lien as security. The taxpayer turned over one-half of the gross proceeds during 1932 to the Company, and the question for decision was whether the one-half of the proceeds paid over to the Company should be included in the gross income of the taxpayer for the year 1932.

This Court held that the Company did not retain any economic interest in the oil in place because of the fact that not only was there a sale of the entire interest, but the Oklahoma Company was not dependent entirely upon the production of oil for the deferred payments. Such payments might be derived from sales of the fee title by the taxpayer.

This case is clearly distinguishable. Not only did the *Anderson* case involve an outright sale, but there the Company was not, as here the taxpayer is, entirely dependent upon production of oil to receive the payments called for. Also in the *Anderson* case, there were (1) no reversionary rights in the Company, and (2) no security for the payments. Here the taxpayer has full reversionary

rights and the lessees' agreement to pay royalties, both gross and net profits, are secured by the oil in place.

The four cases above discussed cannot be said to support the rule the Commissioner is trying to establish; on the contrary these cases establish the following rules:

(1) The acquisition of a contractual right to extract wet gas at the mouth of a well is not an economic interest in the oil in place;

(2) If the right to share in the net profits of the working interest is a mere personal covenant, such right does not, of itself, confer an economic interest in the oil in place;

(3) The complete sale of an economic interest reserving only a right to share in the net profits of the oil producer, does not result in the retention of an economic interest in the oil in place; and

(4) The sale of an economic interest reserving an oil payment does not result in the retention of an economic interest if the working interest may make the oil payment from sources other than the oil and gas produced.

Clearly these cases do not hold that a right to share in net profits of oil production can never constitute an economic interest in the oil in place. Furthermore, the taxpayer can perceive no compelling reason for the promulgation of such a rule. It is clear that in the oil industry a "royalty" may encompass "net profits."[7]

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[7]"Occasionally leases provide for a royalty on oil in the form of a share of the net proceeds of production and sale." 3 *Summer, Law of Oil and Gas* (1938 ed.), Sec. 5.71. "A royalty can consist of a percentage of net profits. 2 *Thornton*, Oil and Gas (Willis, 5th ed. 1932), Sec. 363.

That the parties to the leases involved intended the net profits feature to represent additional royalty is obvious; the Associated Oil Company lease refers to the gross proceeds royalty as "a primary royalty", and the extra payments as "secondary royalty". Also, in defining the secondary royalty, no mention is made of net profits but the lease merely provides that a secondary royalty shall become payable and shall be ascertainable according to specifications therein set forth which first list operating charges or deductions and next specify income credits, and one-half of the difference between the income credits and operating charges is classified as the secondary or additional royalty.

It is clear that in none of the leases involved does the taxpayer participate in the net profits of the lessee in accordance with the usual understanding of the term "net profits". Rather the participation is limited to certain net proceeds derived from operation without regard to deduction of interest and other such expenses of the lessee. It is the same as if the parties had agreed to divide gross proceeds after sharing proportionately in operating expenses.

Had the parties provided for an additional royalty measured by the gross proceeds of the lessee over and above a fixed sum, or a lump sum payment after production had attained a certain level, such gross proceeds or lump sum paid to lessor would have been depletable. The mere fact that the parties selected a particular type of net profits as their yardstick for determining the amount of additional royalties should not change the nature or extent of the taxpayer's economic interest in the oil in place.

Because of the use of "net profits" as a yardstick, the Commissioner labels the secondary royalties as personal

covenants. This conclusion wantonly disregards basic principles of law. The secondary or additional royalties in the taxpayer's leases are not mere personal covenants. They are covenants running with the land, binding the successors in interest of the parties by privity of estate.[8]

No case decided by this Court or the United States Tax Court (formerly Board of Tax Appeals) has ever denied depletion to a fee owner-lessor. On the contrary, with the exception of the decision of the Fifth Circuit Court in the *Kirby* case,[9] every recorded decision has unanimously held that the fee owner upon the execution of an oil lease retaining full reversionary rights in the land and oil, necessarily retains an economic interest in the oil in place and is therefore entitled to depletion on all payments received from the lessee.[10] Thus, even if there were no basic or gross proceeds royalty, the fee owner-lessor should be entitled to depletion.

The Commissioner's argument appears to be bottomed on a syllogistic conclusion drawn from *Helvering v. Elbe Oil Land Development Co., supra,* as a major premise, and *Palmer v. Bender, supra,* as a minor premise. The *Elbe* case held that in an outright sale by the owner of an economic interest in oil, the right to receive a percentage of the vendee's net profits does not constitute the reten-

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[8]Calif. Civil Code, §§ 1460-1464; *Standard Oil Co. v. Slye,* 164 Cal. 435, 129 Pac. 589 (1913); *Richardson v. Callahan,* 213 Cal. 683, 3 Pac. (2d) 927 (1931); *Washburn v. A. F. Gilmore Co.,* 116 Cal. App. 370, 2 Pac. (2d) 506 (1931).

[9]148 Fed. (2d) 80 (1945).

[10]See cases cited in note 3, *supra;* also *Commissioner v. Felix Oil Co.,* 144 Fed. (2d) 276 (C. C. A. 9th, 1944); *Marrs McLean v. Commissioner,* 41 B. T. A. 565, 574 (Gray Lease) affirmed 120 Fed. (2d) 942 (C. C. A. 5th, 1941); Cert. den. 314 U. S. 670 (1941); rehearing den. 314 U. S. 713; *Kirby Petroleum Co. v. Commissioner,* 2 T. C. 1258; *Palmer v. Bender, supra; Burnet v. Harmel, supra; Cf. Anderson v. Helvering, supra.*

tion of an economic interest in the oil in place. *Palmer v. Bender* held that the mere form of a legal instrument does not determine the existence of an economic interest. The Commissioner concludes that whether the parties execute a lease or make a sale is immaterial; the participation in the net profits destroys the economic interest in the oil in place.

Like most syllogistic conclusions, this one contains an inherent fallacy. What the Commissioner has failed to cognize is that in the cases wherein it was decided that the formalities of conveyancer's art are immaterial, the question involved was whether an assignment of a lease which technically operated as a sale of the lessee's interest, should be governed by the legal consequences of the form of the instrument in determining whether royalties in kind should be treated as ordinary income subject to depletion or capital gain.[11]

This Court has never held or even intimated that it is immaterial whether the fee owner sells his land or leases it. On the contrary, as cogently stressed in the *Elbe* and *Anderson* cases, the taxpayers there had made absolute sales of their interests. It was the fact of the absolute sale which made the agreement of the purchaser to pay a portion of net profits a personal covenant.

All of the cases herein cited compel the conclusion that an oil document entered into between the fee owner and the person who is to extract and sell the oil, must, in substance be considered either a lease or a sale. They hold that if the former, there is a retention of an economic interest of the oil in place; if the latter, there may not be.

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[11] *Cf. Burnet v. Harmel, supra.* Technical passage of title to the oil in place according to State law is not determinative.

depending upon the nature of the payments to be made. The Commissioner in the instant case is making the stultifying argument that in one and the same document, which is a typical oil and gas lease, the taxpayer has sold a part of her economic interest in the oil in place and retained a part.

The leases involved do not purport to be anything other than the usual form of an oil lease. The taxpayer, as fee owner, retained all rights of ownership except those specifically granted to the lessee, to-wit: the sole right to explore for, discover and produce oil and gas, and such incidental rights as were necessary for this purpose. Should the lessee not drill, or stop drilling, or fail to pay royalties or default in any of its covenants, the land and oil revert to the lessor.

Technically, under California law, these oil leases do not constitute a sale by the owner of the oil in place, and ownership of the oil and gas does not pass to the lessee until after severance.[12] Likewise, as a matter of substance or consequence for purposes of Federal income taxation without regard to the niceties of state law as to passage of title to oil deposits, these leases cannot be considered as a sale by the taxpayer of any portion of her interest in the oil in place. The words "net profits" in the leases involved cannot have the magic power to convert a simple lease into a partial sale.

The weakness of the Commissioner's position is highlighted by the fact that under certain circumstances it would result in no one being entitled to depletion.

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[12]The fee remains in the lessor; the lessee acquires only a *profit a prendre* to take the oil. *Callaghan v. Martin*, 3 Cal. (2d) 110; *Spalding v. United States*, 17 Fed. Supp. 957 (1937).

It is clear that every barrel of oil taken from the ground depletes someone's economic interest, and someone is entitled to depletion. It is also clear that only a single allowance for depletion may be taken on each barrel of oil extracted and that this allowance must be apportioned between the persons entitled to share in such oil in proportion to their respective interests. *Helvering v. Twin Bell Oil Syndicate, supra.*

The following hypothetical case clearly demonstrates the indefensibility of the Commissioner's argument. Assume that the taxpayer in the instant case had herself drilled and brought in an oil and gas well on her own land. Thereafter she entered into a contract for a period of years with the X Corporation whereby the taxpayer agreed to deliver the wet gas to X through pipe lines at the casing head or trap at the mouth of the well to X's plant where X would extract the gasoline from the wet gas, sell it and pay the taxpayer 33 percent of the gross proceeds received. These assumed facts parallel those of *Helvering v. Bankline Oil Co., supra.* Under the *Bankline* case X would not be entitled to depletion, but the taxpayer would. Assume further that the contract provided that X Corporation would pay the taxpayer 50 percent of its net profits from operations instead of 33 percent of the gross. X would not be entitled to depletion because it does not have an economic interest in the oil in place. According to the Commissioner's argument, neither would the taxpayer be entitled to depletion because she is entitled to receive only the net profits from operation. As the Commissioner would have it, all of the gas in place could be extracted and sold and nobody would be entitled to depletion. The mere statement of this possibility reveals the falsity of the Commissioner's position.

The Commissioner's argument places too much weight upon mere labels. As above shown, the source of the payment made to the landowner cannot always be controlling. The situation is analogous to depletion of cash bonus payments made in advance of drilling. The rule is firmly established that a lessor or sublessor who receives a cash bonus and reserves a royalty interest is entitled to depletion on both. See *e. g., Herring v. Commissioner, supra.* The gross proceeds royalty interest retained represents an economic interest in the oil in place. The cash payment normally made in advance of drilling is deemed to be in partial depletion of the oil reserves and the owner of the royalty interest is entitled to depletion thereon. The payment of a percentage of net profits is analogous to the payment of a bonus in that it is recompense to the land owner for the extraction of oil taken out. The mere fact that the cash bonus is usually limited in amount and paid in advance is immaterial. If the lessee should agree to pay a cash bonus, say of $50,000.00, after a certain number of barrels of oil had been extracted, or after the lessee had received net profits from production equal to a specific amount, it can hardly be contended that no depletion would be allowable on the bonus merely because it is contingent in time and in amount. The controlling factor appears to be that the taxpayer by the execution of the leases reserving a basic royalty interest and retaining full reversionary rights, has not sold any portion of her interest in the oil in place, and all payments received from the lessees are on account of depletion of the taxpayer's interest by production.[13]

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[13]See *Appleman, Taxation of Net Profits from Oil and Gas Properties* (June, 1945), Texas Law Review.

II.

The Decision of the Tax Court Should be Affirmed on the Basis of the Rule of the Dobson Case.

In *Dobson v. Commissioner*, 320 U. S. 489, this Court enunciated the principle that Tax Court decisions have finality "when the Court cannot separate the elements of a decision so as to identify a clear-cut mistake of law * * *."

On questions of fact, the judicial function of the reviewing court is only to determine whether there is warrant in the record and a rational basis for the conclusions of the tax Court.[14]

The sole question involved in the instant case is what was the taxpayer's "gross income from the property." The Tax Court determined that the amounts paid by the lessees to the taxpayer as secondary or additional royalties pursuant to the leases involved constituted gross income to the taxpayer from the property.

The concurring opinion of Mr. Justice Frankfurter in *Trust u/w of Mary Lily (Flagler) Bingham, et al. v. Commissioner, supra*, indicates that the instant case particularly calls for the application of the *Dobson* rule.

The question of what was the taxpayer's gross income from the property during the taxable year is a question bordering on the province of accounting. It calls for "the specialized equipment of the Tax Court and the trained instinct which comes from its experience * * *."

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[14] *W. G. Choate v. Commissioner*, 324 U. S. 1; *Commissioner v. Court Holding Company*, 324 U. S. 331; *Mary Lily (Flagler) Bingham, et al. v. Commissioner*, 65 Sup. Ct. 1232.

This question does not involve any matter outside of the special province of the Tax Court, such as the "constitutional adjudication, determination of local tax questions and common law rules of property, such as the meaning of a 'general power of appointment' or the application of a rule against perpetuities * * *." On the contrary, this question has significance solely as a matter of income tax law. The Tax Court is aware of what really happened in the situation involved, "and what it means in the taxing world." The precise point in issue has been before the Tax Court time and again, always with the same result.[15] Under these circumstances, it can hardly be said that the decision of the Tax Court involved a "clear-cut mistake of law."

III.

If the Net Profit Participations Are Not Subject to Depletion, They Must be Treated as Capital Gain.

In the alternative, the taxpayer contends that if she is not entitled to depletion on the sums involved, they must be treated as capital gain.

In *Anderson v. Helvering, supra,* this Court said:

> "The sole owner and operator of oil properties clearly has a capital investment in the oil in place, if anyone has, and so is taxable on the gross proceeds of production and is granted a deduction from gross income as compensation for the consumption of his

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[15]See *Kirby Petroleum Co.*, 2 T. C. 1258; *Marrs McLean, supra,* Note 9; *Felix Oil Co.*, Memo. Op. Docket 107148; *W. S. Green*, 26 B. T. A. 1017.

capital. See *Burnet v. Harmel, supra*, 287 U. S. at pages 107, 108, 53 S. Ct. 75, 76, 77 L. Ed. 199; *Helvering v. Clifford*, 309 U. S. 331, 60 S. Ct. 554, 84 L. Ed. 788, No. 383, October Term, 1939. By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance. 'The words "gross income from the property," as used in the statute governing the allowance for depletion, means gross income received from the operation of the oil and gas wells by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves.' *Helvering v. Elbe Oil Land Co.*, 303 U. S. 372, 375, 376, 58 S. Ct. 621, 622, 82 L. Ed. 904."

The question therefore would appear to be, is the income derived by the taxpayer gross income from the oil property subject to depletion or income from the sale of the oil and gas properties themselves.

If the proceeds received by the taxpayer by virtue of the net profit participation provisions of the leases are not royalties, *i. e.*, ordinary income subject to depletion, it must be because the taxpayer has sold some portion of her economic interest in the oil in place. If she has sold or parted with some portion of her interest, the transaction must constitute a sale or exchange within the meaning of Section 112 of the Revenue Act of 1938, and of the Internal Revenue Code. This conclusion is ineluctable.

If the net profit participations of taxpayer were capital gain, the taxpayer's income tax liability for the years in-

volved would be substantially less than the amount of income tax liability reported and paid by the taxpayer.[16]

The instant case presents the inverse situation to that involved in *Helvering v. Elbe Oil Co., supra.* In the *Elbe* case, the taxpayer treated the bonus or initial payment of $350,000.00 as a capital gain. The taxpayer then claimed depletion on later payments made pursuant to the sales agreement. The taxpayer placed itself in the anomalous position of treating the transaction as a sale for a consideration taxable as capital gain plus a consideration on which depletion was claimed. In the instant case, the Commissioner, to be logically consistent, should contend that the payments on which it is claimed no depletion is allowable, should be treated by the taxpayer as capital gain. The Commissioner, however, has not carried the logical process this far and has merely denied depletion on the "net profit" participation without characterizing the nature of the moneys received by the taxpayer. The percentage of the net profits of the working interest received by the taxpayer is income, but income does not exist in a vacuum. Moneys received by a taxpayer, either are or are not income by virtue of the nature of the transaction producing the money. In the instant case, they are income either because (1) they are the consideration received by the fee owner for permission to extract oil from the fee owner's property, or (2) they are consideration for a sale by the fee owner of a portion of her interest in the oil in place.

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[16]

Year	Tax Actually Paid	Tax Payable on Basis of Capital Gains	Overpayment
1938	$43,343.37	$21,545.51	$21,797.86
1939	34,650.79	18,122.92	16,527.87
1940	50,026.87	27,449.94	22,576.93

If they fall under the first alternative, they would be gross income from the property subject to depletion; if they fall under the second alternative, they would constitute capital gain subject to special tax treatment. The Commissioner contends that they do not fall within the first alternative, but has failed to place them under the second alternative. In effect, by treating the net profits receipts as ordinary income, the Commissioner has recognized that no sale has taken place of taxpayer's interest, or any part thereof, in the oil in place. If the taxpayer has not sold any portion of her interest in the oil, she has the same capital investment in the oil deposits after the execution of the leases as she had before, and under these circumstances the taxpayer is required to resort to depletion for a return of her capital investment.

Conclusion.

The taxpayer, as owner of the fee, did not sell any portion of her economic interest in the oil in place and all amounts received by her from the three oil leases involved constitute gross income from the property subject to depletion. The decisions of the Tax Court and the Ninth Circuit Court of Appeals do not involve any clear-cut mistake of law and should be affirmed.

Respectfully submitted,

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Dated: October 24, 1945.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 197.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ANNA VICKERS CRAWFORD,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

SUPPLEMENTAL BRIEF FOR RESPONDENT.

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SUPPLEMENTAL BRIEF FOR RESPONDENT.

Prefatory Statement.

Because of time limitations, Respondent's brief was printed and mailed for filing before the receipt of Petitioner's brief. Petitioner's brief incorporates by reference the argument of the Commissioner in his brief in *Kirby Petroleum Co. v. Commissioner*, No. 56 this Term. All references herein are to the Commissioner's brief filed in *Kirby Petroleum Co. v. Commissioner*.

Supplemental Argument.

The Commissioner in his brief argues that as a matter of basic principle a net profit participation in the results of the operating interest can never constitute a royalty (Br. 6-14).

The Commissioner first summarily disposes of the basic point at issue by a flat statement that it makes no difference whether a lease or a sale is involved (Br. 10). The Commissioner offers no direct authority for this sweeping statement. There is none. This is a primary issue in this case. See Respondent's main brief, pages 20-22. And as will be developed more fully herein, this difference between a lease and a sale is the decisive factor in this case.

After assuming this point at issue, the Commissioner argues that a depletable interest cannot exist unless it has a direct relationship to production (Br. 12). It simply does not follow that a share in the net profits of production retained by a lessor cannot constitute a royalty. Production necessarily precedes net profits from operation and if the lessor does receive a portion of the net profits of the operating interest, by hypothesis, there has been production. The mere fact that there may be production with no net profits does not imply that the fee owner has parted with any portion of his economic interest in the oil in place or that what he does receive is not a royalty. The fact that he is willing to take a chance on the net economic results of the exploitation of his economic interest does not mean that he has parted with such interest. He may receive little or nothing. On the other hand, he may receive a great deal; but whatever he does receive is solely the result of production of oil from his land. This argument of the Commissioner has no bearing one

way or the other upon the determination of the issue involved.

The Commissioner further argues that the rule of apportionment of the deduction for depletion between lessor and lessee necessarily precludes depletion in the case of a net profit participation. Taxpayer fails to see the significance of this argument. The necessity for apportionment is conceded. The formula therefor was laid down by this Court in *Helvering v. Twin Bell Syndicate*, 293 U. S. 312, and this formula operates as effectively in the case of net profit participation royalties as in any other type of royalty. The question in the *Twin Bell Syndicate* case was the determination of the amount of gross income from the property to the working interest. This Court held that gross income from the property to the working interest subject to depletion "means gross income from production less the amounts which the taxpayer was obligated to pay as royalties." The Commissioner argues at page 13 of his brief that it follows from this case that the depletion allowance must be apportioned in accordance with the respective interests of the parties in the gross production of the oil or the gross income therefrom. Here again the Commissioner is lifting himself up by his bootstraps. If the net profit participation of the fee owner-lessor constitutes a royalty, the gross income to the working interest subject to depletion means gross income less amounts he has to pay to the lessor by way of the lessor's net profit participation. Clearly the *Twin Bell Syndicate* case does not support the Commissioner's assertive statements that a lessor must participate in gross production in order to have a depletable interest.

The Commissioner relies in part upon *Anderson v. Helvering*, 310 U. S. 404, to support his statements that

only a participation in gross production constitutes a royalty. It must be remembered that the *Anderson* case involved an outright conveyance or sale of an economic interest in the land. In such circumstances, if an interest in gross production by way of an oil payment is retained, the vendor has a royalty because he has an assurance of participation in production. In cases involving a sale, the owner of an economic interest purports to part with his entire ownership. However, this Court has held that if the owner retains an interest in gross production by way of an oil payment, he has reserved from his sale a depletable economic interest, but if the specific sum to be paid may be paid by the vendee out of sources other than the oil, the vendor has not reserved an interest which can be characterized as an oil payment or royalty subject to depletion. *Anderson v. Helvering, supra.*

The *Anderson* case should not be extended beyond its facts. When there is a sale or a conveyance by which the owner or lessee has effectively parted with his entire legal interest, it is necessary to look to the method of payment by the vendee to determine whether the vendor has retained an economic interest in the oil. An interest in gross production in such case, *i. e.*, a traditional royalty or oil payment, represents an economic interest in the oil in place, whereas a participation in the vendee's net profits does not. *Anderson v. Helvering, supra; Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372. But these principles are not applicable to leases by the fee owner. The reversionary interest of the fee owner of itself constitutes an economic interest in the oil.

The Commissioner places too much reliance on *Palmer v. Bender*, 287 U. S. 551. In that case, the lessee of certain oil properties assigned his interest in considera-

tion of a cash bonus, an oil payment and a gross royalty. The lessee claimed depletion on all payments received from his assignee. The Commissioner argued that the assignment under state law constituted an outright sale leaving no reversionary interest in the assignor. Consequently the payments received by the lessee were not royalties subject to depletion but were taxable as capital gain. In this case, the Commissioner conceded "that, if any reversionary interest, according to the common law, however small, has been retained in the leased land by the two partnerships, the petitioner is entitled to the depletion allowances claimed." 287 U. S. at 553.

This Court held that in the case of a complete assignment of this nature, it was immaterial whether the form of the document constituted an assignment or a sublease according to state law; that the formal attributes of the instruments or the descriptive terminology which may be applied to them *according to the local state law* are irrelevant. The holding of this case is not that the form of legal relationship created must in every instance be disregarded. Its essence is that although the parties may have effected a sale as a matter of form, if the vendor has retained an interest in gross production of the vendee, he has carved out of the rights sold and retained an economic interest in the oil in place.

It is vitally significant that in all the cases relied upon by the Commissioner, the question presented has been whether or not in the case of a sale the payment involved represented a royalty subject to depletion. In such cases the nature of the payment is determinative. A lease by the fee owner which cannot possibly be construed as a sale presents an entirely different situation. *Burnet v. Harmel*, 287 U. S. 103 is wholly in point. This case

involved the execution of an oil lease by the owner in fee of Texas oil lands in consideration of a bonus and a royalty measured by the gross production of oil. The taxpayer took the position that under Texas law the leases constituted a present sale of the oil in place, and treated the payments received from the lessee as gain from the sale of a capital asset. This Court held that the lease conformed to the usual type of oil lease and that it was immaterial that under the law of Texas title to the oil in place passed to the lessee. The economic consequences of the lease were that the lessee acquired the right to enter upon and use the land for the purpose of exploiting the oil and gas and that all oil and gas not extracted remained the property of the lessor upon the termination of the lease. Such a transaction does not constitute a sale or conversion of a capital asset. Accordingly, it was held that what the lessor received was a royalty.

Thus it is perfectly proper to conclude that in the event of the execution by the fee owner of an oil document which purports to be an absolute sale of his entire interest, it is necessary to look to the method of payment by the vendee to determine whether an economic interest in the oil has been retained by the vendor; whereas, in the case of an execution by the fee owner of a typical oil lease, the legal consequences of the form of the lease and the method of payment by the lessee (gross or net results of drilling) are immaterial because the lessor by virtue of his reversionary interest, if nothing else, retains an economic interest in the oil in place.

The Commissioner states that Treasury Regulations support his position (Br. 19, 25). Examination of the pertinent provisions of Treasury Regulations 103, namely

Section 19.23 (m)-1, as quoted on page 19 of Commissioner's brief, clearly refutes the Commissioner's position. These Regulations merely incorporate the principle of *Helvering v. Bankline Oil Co.*, 303 U. S. 362, to the effect that an agreement between the *owner* of an economic interest and *another* entitling the latter to share in the net income derived from the interest of such *owner* does not convey a depletable economic interest. Here the taxpayer is the owner. She is not acquiring from another owner an interest in net profits, but has granted another person the right to exploit her economic interest in consideration of a share of the net profits of the exploiter. The *Bankline Oil Co.* case (Resp. Main Brief 11, 21) has no bearing on the factual situation presented in the instant case. Treasury Regulations do not support the Commissioner. In fact, the Commissioner has been treating the net profit participation of the taxpayer as a royalty subject to depletion for years and it was not until after the issuance in 1941 of G. C. M. 22730, 1941-1 C. B. 214, that the Commissioner began to take the position that a lessor's participation in net profits of the lessee could not constitute a royalty.

The Commissioner has attempted to support his position that the net profit participation can be fully taxed as ordinary income with no allowance for depletion (Br. 25-28) with the vague statement that so far as the lessor is concerned, the payment has all the attributes of ordinary income. What are "the attributes of ordinary income"? This question depends upon the relationship of the parties and the reason for the payment. In *Schermerhorn Oil Corp. v. Commissioner*, 46 B. T. A. 151 (Br. 26) the net profit payments were held to be ordinary income to the payee because he was an employee of the operating oil

company. The payments were deemed to be additional compensation for services rendered. In *Burnet v. Harmel, supra* (Br. 26), the payments were income to the lessor, *but the lessor was allowed depletion thereon.* In *Sunray Oil Co. v. Commissioner*, 147 F. (2d) 962 (C. C. A. 10th), cert. den. May 21, 1945, the payment made by the oil company was a bonus which, while a capital investment by the oil company deductible in computing its gross income from the property, was income to the recipient, *but the recipient was entitled to take depletion against the bonus.*

There is no question here but that the payments received by the lessor are income. The only question is, are they royalty income or some other type of income? The Commissioner, after arguing that the payments are not royalty income, states "because of its continuing interest in production by way of oil royalties, the lessor has not made a sale of any capital asset" (Br. 26).[1] The Commissioner thus focuses the crucial issue in this case. Why are the payments made to the lessor income? Obviously, if they are made for the sale of a capital asset, the excess amount received over cost would be capital gain income. If they are not received as consideration for the sale of an asset, they must be consideration for the execution of the lease. In such case, they constitute consideration paid by the lessee for the right to extract and sell oil, a recompense to the owner for the exhaustion of the oil in place; in other

[1] *Cf.* Commissioner's brief, page 23, wherein the argument indicates that if the payments do not represent a royalty, they are "regarded as proceeds from the interest sold." The cases cited by the Commissioner on page 23 held that the payments not considered as royalties should be treated as capital gain resulting from the sale or conversion of a capital asset.

words, a royalty or gross income from the property subject to depletion.

Consider the intolerable situation resulting from the Commissioner's argument. Assume that T owns land containing oil deposits and has a cost basis therefor of $1,000,000.00. T executes a lease with a drilling company requiring the payment of a royalty equal to one-half of the net profits from the sale of oil. For a period of twenty years thereafter, T receives as his share of the results of drilling, $500,000.00 per year or a total of $10,000,000.00. At the end of twenty years the wells go dry and the land reverts to T.

The Commissioner assumes (Br. 20) that in this situation T is not entitled to depletion.[2] He also takes the position that the taxpayer has not sold any part of his interest so as to result in capital gain. What would be the tax result? T pays taxes on $10,000,000.00, receives back his land exhausted of all oil content and still has his cost basis of $1,000,000.00 which has not been recouped by deductions for depletion, or by deduction against sales price. T's valuable asset which cost him $1,000,000.00 has been exhausted but he still holds valueless land at a cost of $1,000,000.00. This is in effect a tax on capital.

This situation cannot be permitted to exist. Either T is entitled to depletion deductions as his asset is being

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[2] *Felix Oil Co. v. Commissioner*, 144 F. (2d) 276 (C. C. A. 9th), held to the contrary. The Ninth Circuit Court relied in part on the *Felix* case in affirming the decision of the Tax Court in the instant case. The Tax Court in the instant case and in *Kirby Petroleum Co.*, 2 T. C. 1258, did not rely solely on the fact that a gross royalty had been retained by the lessor. The Commissioner has misinterpreted *Estate of Japhet*, 3 T. C. 86 (Br. 20). The *Japhet* case involved an outright sale and was decided on the basis of *Helvering v. Elbe Oil Land Development Co., supra.*

wasted or he is entitled to deduct his cost from the proceeds received and treat the excess as capital gain. To say that T in this situation merely "has contracted for and has received an economic advantage resulting from the operator's ability to earn profits" (Br. 26) is to ignore salient economic facts.

The Commissioner further confuses the issue (Br. 31-34) by assuming that depletion must be equated in terms of barrels. There is no reason why the amount of royalties subject to depletion, *i.e.*, gross income from the property, must be expressed in terms of barrels. There is no necessary relationship between advance bonuses and the number of barrels of oil extracted, yet advance bonuses are subject to depletion. Viewed from this advantage, the complex problem presented by the Commissioner (Br. 31-34) vanishes into thin air. In the Commissioner's example the total royalties of the lessor are $61,500.00 and not so many barrels of oil. The gross income of the lessee is $345,000.00 which need not be phrased in terms of barrels of oil. The lessee would report as gross income from the property the sum of $345,000.00 less the royalties he is required to pay to the lessor of $61,500.00. The lessee would report $283,500.00; the lessor $61,500.00. No sum whatsoever disappears from the total gross income of the property which must be reported for tax purposes. Thus the dilemma posed by the Commissioner (Br. 33) becomes illusory. The question here is not how many barrels was the lessor entitled to receive from the lessee, but what is the true nature of the payment made by the lessee to the lessor.

The Commissioner contends for the rule that a royalty must mean a share in gross production. (Br. 37.) There is nothing to commend this proposition except simplicity.

Certainly there is no valid reason which can be advanced why a royalty must always be defined in terms of gross production. So long as the proceeds received by the land owner pursuant to a lease flow from and are the results of production alone, they constitute a royalty subject to depletion. The law should not be warped to the rigid confines of a rule which results in economic distortion of fact merely because the rule is simple and easy to apply.

Conclusion.

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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